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American Institute of Certified Public Accountants. Credit Unions Committee

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EXPOSURE DRAFT

PROPOSED AUDIT AND ACCOUNTING GUIDE

AUDITS OF CREDIT UNIONS

OCTOBER 21, 1983

Prepared by the Credit Unions Committee
of the American Institute of Certified Public Accountants

Comments should be received by January 20, 1984, and addressed to
Allen L. Cooper, Federal Government Relations, File L-1-101
AICPA, 1620 Eye Street, N.W., Washington, D.C. 20006

814142

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036-8775 (212) 575-6200

October 21, 1983

Accompanying this letter is an exposure draft of a proposed AICPA audit and accounting guide, Audits of Credit Unions. A summary of the proposed guide also accompanies this letter.

The guide discusses those aspects of accounting and auditing that are unique to the credit union industry. It was developed to assist independent auditors in their examination of financial statements of credit unions.

Comments or suggestions on any aspect of this exposure draft will be appreciated. Commentators on the proposed guide are specifically requested to give particular attention to the proposed classification of savings (share) accounts as liabilities, instead of equity, which is discussed in chapter 8. The committee's consideration of responses will be helped if the comments refer to specific paragraph numbers and include reasons for any suggestions or comments.

Responses should be addressed to Allen L. Cooper, AICPA, Federal Government Relations Division, 1620 Eye Street, N.W., Washington, D.C. 20006, File L-1-101, in time to be received by January 20, 1984.

Written comments on the exposure draft will become part of the public record of the AICPA Federal Government Relations Division and will be available for public inspection at the offices of the American Institute of Certified Public Accountants after February 20, 1984, for one year.

Sincerely,

Clifford Heffner
Chairman
Credit Unions Committee

Joseph F. Moraglio
Director
Federal Government
Relations Division

SUMMARY

This proposed audit and accounting guide describes operations and accounting practices that are unique to the credit union industry as well as matters that are unique to the audit of a credit union's financial statements. In addition, it describes some of the regulatory requirements of the industry.

The proposed guide states that savings (share) accounts in a credit union should be classified as liabilities on the credit union's statement of financial condition. This presentation is consistent with the prevailing practice in mutually owned savings and loan associations and savings banks. Furthermore, it is consistent with the concept of liabilities expressed in FASB Statement of Accounting Concepts No. 3, *Elements of Financial Statements of Business Enterprises.* Paragraph 29 of Concepts Statement No. 3 states:

> A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of specified event, or on demand, (b) the duty or responsibility obligates a particular enterprise, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the enterprise has already happened.

There are those who believe that savings (shares) should be classified as equity for the following reasons:

- *Shares are legally defined as equity.* The organizers of the credit union movement desired that credit union members have an ownership equity interest in their credit union in the form of $5 par value stock. Since 1934, the Federal Credit Union Act has stated that "Federal credit union membership shall consist of the incorporators and such other persons and incorporated and unincorporated organizations . . . as may be elected to membership and as such shall each subscribe to at least one share of its stock and pay the initial installment thereon." Also since 1934, the Federal Credit Union Act has provided federal credit unions with the corporate form of organization, membership to which is limited to persons who share a specific common bond. A corporation cannot exist without the availability of stock. Congress, therefore, provided for the corporate form of member (stockholder) ownership, supporting it with the required purchase of stock (shares). Shares are thus legally defined as equity.
- *Shares function as equity and represent ownership.* Unlike depositors in other financial institutions, members control the credit union through periodic or special elections of officials and through other voting rights. The statutory one member–one vote provision of section 110 (12 U.S.C. 1760) of the Federal Credit Union Act is a cooperative principle assuring democratic control. Only those members who have purchased a share, or an initial installment thereon, may vote as prescribed in section 109 (12 U.S.C. 1759) of the Federal Credit Union Act. A member's vote cannot be passed to another member proxy. Members thus retain control over their collective equity interests in their credit union.
- *As with any corporate stock, shares are at risk.* From the viewpoint of capital, there is the possibility of gain as well as of loss. A gain can be derived in the form of unguaranteed and unlimited dividends that are generally computed based on the number of par value shares a credit union member has outstanding and the availability of retained (surplus) earnings after statutory reserve requirements have been satisfied. A gain may also be derived from a pro-rata distribution of surplus earnings resulting from a credit union's voluntary liquidation or merger. On the other hand, members may experience a pro-rata loss of their *uninsured* shares if their credit union enters liquidation. From the viewpoint of earnings, a member may also experience a loss from his share purchases when sufficient earnings are not available from the credit union to pay competitive dividends.

In summary, shares function as equity and those functions are unique to the concept of what a credit union is and what it represents in the world of financial institutions—a cooperative pooling of funds (equity) to be managed for the benefit of the member owners.

The Credit Unions Committee specifically requests comments on the classification of savings (share) accounts of credit unions.

This exposure draft has been sent to

- *State society and chapter presidents, directors, and committee chairmen.*
- *Organizations concerned with regulatory, supervisory, or other public disclosure of financial activities.*
- *Individuals and firms identified as having an interest in credit union accounting and auditing.*
- *Persons who have requested copies.*

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PREFACE

1. This audit and accounting guide has been prepared to assist the independent CPA in examining and reporting on financial statements of credit unions. Additionally, it should help the supervisory committee, management, and directors of credit unions, as well as other interested persons, understand the nature and scope of audits of credit unions by independent CPAs.

2. This guide emphasizes those aspects of accounting and auditing unique to the credit union industry, reflecting the presumption that the CPA understands accounting and auditing aspects that are common to business enterprises in general. The guide presents typical audit situations in credit unions, including the CPA's study and evaluation of internal accounting controls; however, the discussions do not necessarily cover all situations that a CPA might encounter in a specific credit union.

3. Finally, references to AICPA Statements on Auditing Standards and to the authoritative accounting pronouncements of the Financial Accounting Standards Board (FASB) and its predecessor organizations, including the Accounting Principles Board (APB) and the Committee on Accounting Procedure, are intended to include the specific pronouncements as well as all subsequent amendments and interpretations through ___________, 198__. The CPA should be familiar with any authoritative auditing and accounting pronouncements issued after that date.

Credit Unions Committee

Chapter 1

ORGANIZATION AND SUPERVISION

THE U.S. CREDIT UNION MOVEMENT

4. Although the credit union movement began in the United States as long ago as 1909, the number of credit unions has grown rapidly and continuously since the enactment of the Federal Credit Union Act in 1934. Similar legislation has been enacted by the states.

5. Credit unions are cooperatives owned, directed by, and dedicated to serving members who are united by a common bond of professional or social identity. Credit unions are exempt from federal income taxes, and most are exempt from state and local income taxes. As traditional savings and lending institutions, they have long played an important role in individual savings and consumer installment loans. As a result of recent legislative and regulatory changes, credit unions may now offer expanded services, for example, new deposit instruments, share drafts, long-term real estate loans, credit cards, and electronic based funds systems, such as automated teller machines.

ORGANIZATION AND STRUCTURE

6. Although the organization of credit unions is similar to that of mutual financial institutions, volunteers make many decisions in most credit unions. The law requires that the board of directors and a supervisory committee of a credit union be elected or appointed from its membership. In addition, a credit committee may be appointed or elected to oversee the lending transactions. The supervisory committee — similar to an audit committee — plays a major role in monitoring the credit union's affairs.

7. The supervisory committee is charged by law with the responsibility of supervising the system of internal accounting control and the audit activities of the credit union. Because the committee usually engages a CPA to examine and report on the credit union's financial statements, the CPA performs these services usually at the request of the supervisory committee on behalf of the credit union members. (See chapter 2 for a discussion of the supervisory committee.)

8. A number of trade organizations are involved in the regulatory and legislative affairs of the credit union industry. Two of these organizations, the Credit Union National Association (CUNA) and the National Association of Federal Credit Unions (NAFCU), play key roles. CUNA also provides such services as supplies, marketing, insurance, fund transfers, and investment instruments through its affiliates.

GOVERNMENT SUPERVISION

9. A credit union operates under a federal or state charter and is therefore subject to government supervision and regulation, including periodic examinations by supervisory agency examiners. A federally chartered credit union is supervised by the National Credit Union Administration (NCUA), which is responsible for administering the National Credit Union Share Insurance Fund (NCUSIF). The NCUSIF provides share insurance to all federal and federally insured, state-chartered credit unions and insures each deposit up to a specified amount. In return for this protection to its members, each credit union pays an assessment based on its total savings accounts.

10. A state-chartered credit union is regulated by the supervisory agencies of the chartering state. They have the option of obtaining NCUSIF share insurance coverage or securing insurance from other sources.

11. The Depository Institution Deregulation and Monetary Control Act of 1980 significantly changed reserve requirements for financial institutions, calling for insured depository institutions, including credit unions, to maintain reserve balances within the Federal Reserve System.

NATIONAL CREDIT UNION ADMINISTRATION

12. Over 60 percent of all credit unions are federally chartered by the NCUA, which issues regulations for both federal credit unions and federally insured, state-chartered credit unions. States adopt their own regulations for state-chartered credit unions. Several NCUA publications provide useful background information to auditors who serve credit unions:

- *Accounting Manual for Federal Credit Unions*
- *Credit Manual for Federal Credit Unions*
- *Supervisory Committee Manual for Federal Credit Unions*
- *National Credit Union Administration Rules and Regulations*
- *The Federal Credit Union Act*
- *Federal Credit Union Bylaws*
- *Annual Report of the National Credit Union Administration*

Chapter 2

AUDITING CONSIDERATIONS

AUDITING IN A CREDIT UNION ENVIRONMENT

13. As used in this guide, the term *audit* refers to an examination made by a CPA in accordance with generally accepted auditing standards for the purpose of expressing an opinion on a credit union's financial statements (unless the context clearly indicates that the reference is to an internal audit); the term *examination* generally refers to an examination made by a supervisory authority. An important purpose of a supervisory examination is the protection of credit union members, and, accordingly, the supervisory agency examiner emphasizes the quality of assets, liquidity, adequacy of retained earnings, management ability, future earnings ability, and compliance with applicable laws and regulations. Supervisory examinations also emphasize the review and classification of loans. Although an audit also covers those areas, the auditor's scope generally is broader, enabling the auditor to state an opinion on the financial statements as a whole.

PLANNING THE AUDIT

14. In planning the audit of financial statements of a credit union, the auditor usually performs a preliminary review of financial data and reviews internal audit reports, reports of examinations by supervisory agencies, and related correspondence. Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision*, contains general guidance on planning an audit.

15. Examples of the types of information that may be assembled when planning the audit, and the arrangements to be considered, include the following:

1. General
   - Engagement letter
   - Location of offices
   - Office hours of employees
   - Hours open to the public for business
   - Audit personnel requirements — interim and year-end
   - Letters of accreditation for audit personnel
   - Types of bookkeeping or data processing equipment
   - Daily closeout procedures
2. Internal Accounting Control
   - Policy and procedure manuals and organization charts
   - Main office and branches
   - Data processing installations (including service bureaus)
3. Cash and Consigned Items
   - Number of tellers
   - Number of bank accounts
   - Approximate volume of receipts and disbursements (number of transactions)
   - Number and location of cash funds (other than teller funds)
   - Location of consigned items (such as money orders and traveler's checks)
4. Investment securities
   - Location of securities
   - Volume of transactions
5. Loans
   - Number of accounts by major classes of loans
   - Existence of loans and participations purchased or sold
   - Location of detail and control accounts
   - Location of all collateral and supporting documentation
6. Savings Accounts
   - Types of accounts offered
   - Number of accounts
   - Location of detail and control accounts
   - Interest payment dates
   - Existence of accounts that request "no correspondence"
   - Procedures for dormant accounts
7. Other Items
   - Access to minutes
   - Subsidiaries of the credit union (such as service corporations)
   - Major accounting policies
   - Related parties (including sponsor organizations)
   - Types of borrowed funds (including Central Liquidity Fund (CLF) advances, bank loans, collateralized borrowing agreements, or other borrowings)

TIMING OF THE AUDIT

16. Based on several factors,[1] the auditor may determine that a significant amount of the audit can be performed at an interim date. In such cases, year-end procedures can be limited to such matters as analytical review procedures and investigation of unusual transactions and significant fluctuations for the period from the interim date to the statement of financial condition date, as well as any additional substantive tests and other audit procedures deemed necessary. However,

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[1] An exposure draft of a proposed Statement on Auditing Standards, *Timing of Substantive Tests*, dated October 1, 1982, identifies factors to be considered:

4. Before applying substantive tests to the details of asset or liability accounts at an interim date, the auditor should assess the incremental difficulty in controlling ultimate risk. In making that assessment, the auditor should consider—

a. Whether adverse conditions or factors are present that add to the difficulty in controlling ultimate risk.
b. Whether the effectiveness of certain substantive tests covering the remaining period might be impaired by the absence of particular internal accounting control procedures.
c. Whether sufficient evidential matter will be available at both the interim date and the balance-sheet date and concerning the transactions that occur between those dates.
d. Whether audit conclusions drawn from the interim work might not remain valid at the balance-sheet date.

if the auditor relies on internal accounting controls to reduce his substantive tests, he should be satisfied that the internal accounting control procedures on which he relied remain in effect at year-end. Sections 310.05 through .09 and 320.64 through .67 (as amended by SAS No. 43) of SAS No. 1, *Codification of Auditing Standards and Procedures*, provides guidance about timing the tests of compliance with internal accounting control procedures.

17. Most credit unions end their fiscal year on December 31, but the date of the financial statements being audited may not coincide with the fiscal year-end of the credit union. Timing of the audit should be agreed upon with the supervisory committee.

RISKS IN THE CREDIT UNION INDUSTRY

18. To determine the scope of audit procedures to be performed, the auditor should be aware of certain factors peculiar to the credit union industry.

19. There are economic risks. As supply and demand for credit fluctuates, the effect on interest rates entails risks for credit unions. As money becomes tighter and interest rates rise, various risks become more pronounced.

20. The *credit risk* is significant in most credit unions. The following factors may cause loans to develop credit risk problems:

- Improper credit extension procedures
- Changes in the national economy or in the credit union's specific geographical area
- Changes in the status of a particular industry (and/or the sponsoring organization)
- Undue loan concentration
- Deterioration in the credit worthiness of the borrowers

Loan quality is the principal factor in consideration of the adequacy of the allowance for loan losses.

21. Credit unions are exposed to *interest rate risk* when their assets are subject to legal interest rate ceilings or are invested in intermediate- or long-term fixed-rate loans or securities and when these assets are funded through interest-sensitive short-term liabilities. If management misjudges the movement of interest rates and the rates rise substantially, the credit union must refinance short-term borrowing at higher rates, which may result in lower overall profit margins or an overall loss.

22. Credit unions are exposed to *liquidity risk* when they invest disproportionately in long-term securities, which generally decrease in market value when interest rates rise. If a credit union is forced to sell these investments to generate cash, large losses may be incurred on the transactions. If the credit union's liquidity is not sufficient to meet prospective needs, and if there is evidence that the credit union may have to dispose of certain assets to attain liquidity, the auditor should consider the propriety of the accounting basis for any assets that the credit union may sell. In more serious situations of illiquidity, the auditor may also need to refer to SAS No. 34, *The Auditor's Considerations When a Question Arises About an Entity's Continued Existence*.

AUDIT OBJECTIVES

23. SAS No. 31, *Evidential Matter*, provides the auditor with guidance on the third standard of field work, stating:

> In obtaining evidential matter in support of financial statements assertions, the auditor develops specific audit objectives in the light of those assertions. In developing the audit objectives of a particular engagement, the auditor should consider the specific circumstances of the entity, including the nature of its economic activity and the accounting practices unique to its industry.

These assertions can be classified into five broad categories:

- *Existence or occurrence*. Do assets or liabilities of the entity exist at a given date, and have recorded transactions occurred during the given period?
- *Completeness*. Are all transactions and accounts that should be presented in the financial statements included?
- *Rights and obligations*. Do all assets belong to the entity, and are all liabilities obligations of the entity at a given date?
- *Valuation or allocation*. Are all components of the financial statements stated at their appropriate amounts?
- *Presentation and disclosure*. Are components of the financial statements properly classified, described, and disclosed?

24. Specific audit objectives that are unique to the credit union industry and that might be developed to evaluate the evidential matter supporting management's assertions in the financial statements are discussed in later chapters.

INTERNAL ACCOUNTING CONTROL

25. The second standard of field work states:

> There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

26. The nature of the audit procedures selected, their timing, and the extent of their application may depend on the degree of reliance to be placed on the system of internal accounting control. The auditor's study and evaluation of the system, as a basis for restricting the scope of audit tests to be performed, involves both the initial inquiry necessary to ascertain the credit union's procedures and those additional investigations, tests, and inquiries performed during the audit to test compliance with established internal accounting

control procedures. Preparation of flowcharts is often helpful in reviewing the design of the system of internal accounting control.

27. SAS No. 43, *Omnibus Statement on Auditing Standards*, clarifies the minimum study and evaluation of the system of internal accounting control contemplated by the second standard of field work. The review of internal accounting control may be limited to obtaining an understanding of the control environment and the flow of transactions. After this minimum study and evaluation of the system of internal accounting control, the auditor may decide not to rely on the system to restrict his substantive tests and design his audit procedures accordingly.

28. Section 320 of SAS No. 1 discusses the study and evaluation of internal accounting control. If the credit union has an internal audit function, the auditor should consult SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination*.

29. Internal accounting controls over cash, consigned items, loans to members, investments owned, savings accounts, and the handling of transactions related to those items are especially important in credit unions. For example, cash-handling functions should be segregated, to the extent practicable, from related record-keeping responsibilities. Adequate controls should be established over savings accounts, including inactive accounts; lending procedures, including loan approvals; document control; and loan disbursements.

30. The independent auditor may become aware of material weaknesses in the system of internal accounting control during the performance of the audit. SAS No. 20, *Required Communication of Material Weaknesses in Internal Accounting Control*, requires that such weaknesses be reported to the senior management and to the board of directors. In a credit union the supervisory committee normally receives this report.

31. The NCUA and some state regulators may require that they be provided with a report of recommendations for procedural changes that would strengthen existing internal accounting control. SAS No. 30, *Reporting on Internal Accounting Control*, describes the CPA's report on internal accounting control based solely on a study and evaluation made as part of an audit (paragraphs 47 through 53) and other special-purpose reports (paragraphs 60 through 61).

32. The auditor should be familiar with the section in the NCUA's *Accounting Manual for Federal Credit Unions* titled "Internal Controls," which discusses administrative and accounting controls. It also identifies, in chart form, positions in federal credit unions that may not be held concurrently.

33. Appendix B of this audit guide summarizes control procedures and conditions the auditor may wish to consider when performing a study and evaluation of internal accounting control in connection with either an audit or a special engagement.

APPLICATION OF AUDIT SAMPLING

34. Several credit union audit procedures may entail audit sampling. Such procedures may include tests to determine compliance with specified internal accounting control procedures or substantive tests of balances, such as requests of confirmation for the savings and the loan accounts of the members.

35. SAS No. 39, *Audit Sampling*, provides guidance for planning, performing, and evaluating audit samples, and it applies equally to nonstatistical and to statistical sampling. The statement also includes discussions intended to enhance professional judgment in assessing sampling risk, planning samples, sample selection, and performance and evaluation.[2]

[2] An audit guide, *Audit Sampling*, was issued by the AICPA in 1983. This guide provides guidance to assist auditors using either statistical or nonstatistical audit sampling in applying SAS No. 39.

AUDITING AND ELECTRONIC DATA PROCESSING (EDP) SYSTEMS

36. Many credit unions use some form of an EDP system, which may be operated solely by the credit union, shared with others, or provided by an independent organization for a fee. Typical applications of EDP systems are loans, savings, payroll, and general ledger. In addition, some credit unions may be involved in such activities as direct deposit, electronic funds transfer, automated clearing house, preauthorized allotment receipts, automated teller units, and telephone bill payer operations.

37. The use of EDP equipment does not affect the objectives of the audit; however, the organizational and control procedures used may differ from those used in manual or mechanical data processing, and audit procedures applied to accounting records maintained on EDP equipment may vary from those applied to records maintained manually or on mechanical equipment. This guide does not discuss the effects of EDP on an audit.

38. Guidance in auditing records in which EDP processing is significant is contained in the following documents:

- SAS No. 3, *The Effects of EDP on the Auditor's Study and Evaluation of Internal Control*
- SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*
- AICPA Audit and Accounting Guide, *The Auditor's Study and Evaluation of Internal Control in EDP Systems*
- AICPA Audit Guide, *Audits of Service-Center-Produced Records*
- AICPA Audit and Accounting Guide, *Computer Assisted Audit Techniques*
- AICPA Computer Services Guidelines, *Audit Considerations in Electronic Funds Transfer Systems*

The auditor may also consult the Federal Financial Institutions Examinations Council's *EDP Examination Handbook*, which includes a section titled "Internal and External EDP Audit."

CLIENT REPRESENTATIONS

39. SAS No. 19, *Client Representations*, requires the auditor to obtain certain written representations from management as part of an audit and provides guidance concerning these representations. The specific written representations to be obtained depend on the circumstances of the engagement and on the nature and basis of presentation of the financial statements. Paragraph 4 of SAS No. 19 lists matters ordinarily included in management's representation letter. Certain other representations related to credit union operations are normally obtained from credit union clients. These other items include, but are not necessarily limited to, representations that—

- All contingent assets and liabilities, including loans charged off, have been adequately disclosed in the financial statements, where appropriate.
- Adequate provision has been made for any losses, costs, or expenses that may be incurred on securities, loans, or leases as of the statement of financial condition date.
- Liabilities are adequate for interest on deposits and on borrowed funds.
- Permanent declines in value of securities have been properly reported in the financial statements.
- Commitments to purchase or sell securities have been adequately disclosed in the financial statements, where appropriate.

THE SUPERVISORY COMMITTEE

40. Section 115 of the Federal Credit Union Act states:

> The supervisory committee shall make or cause to be made an annual audit and shall submit a report of that audit to the board of directors and a summary of the report to the members at the next annual meeting of the credit union; shall make or cause to be made such supplemental audits as it deems necessary or as may be ordered by the Board, and submit reports of the supplementary audits to the board of directors.

Similar requirements may exist for state-chartered credit unions.

41. The nature, timing, and extent of the audit procedures to be performed and the resulting reports to be issued are determined by the auditor and are based on the type of engagement, as established by the supervisory committee. Before starting the audit, the auditor should meet with the supervisory committee to establish and agree on the scope of services to be performed. Many auditors specify in the engagement letter the services to be performed.

COMPLIANCE WITH REGULATIONS

42. Although the ultimate responsibility for compliance with applicable laws and regulations rests with management, auditors should consider laws and regulations that have a direct effect on the amounts presented in the financial statements.

43. Typically, regulations issued by the supervisory agencies, the Federal Reserve Board, and other government agencies address such issues as accounting standards, qualifications for membership, interest rate controls, legal investments, consumer protection issues, liquidity reserves, and other operational aspects. A review of the latest reports of supervisory examinations should disclose any related deficiencies. The auditor should also review consumer compliance reports and EDP third-party reviews for deficiencies. Although some deficiencies or instances of noncompliance may not directly affect the financial condition of the credit union, failure to adhere to applicable laws and regulations may result in operational restrictions or monetary penalties against the credit union.

44. SAS No. 17, *Illegal Acts by Clients*, provides guidance in dealing with an act that appears to be illegal, discusses the extent of attention the auditor should give when performing an examination, and sets forth considerations applicable to notification of other parties.

45. SAS No. 17 also outlines the auditor's practical limits of the audit. Paragraph 3 states:

> An examination made in accordance with generally accepted auditing standards cannot be expected to provide assurance that illegal acts will be detected. In reporting on financial statements, an auditor holds himself out as one who is proficient in accounting and auditing. The determination of whether an act is illegal is usually beyond his professional competence. The auditor's training and experience, however, ordinarily should provide a reasonable basis for an awareness that some client acts coming to an auditor's attention in the performance of his examination might be illegal. Nevertheless, the further removed an illegal act is from the events and transactions specifically reflected in financial statements, the less likely the auditor is to become aware of the act or recognize its possible illegality.

46. The auditor should be aware of the possibility that illegal acts may have occurred that could have a material effect on the credit union's financial statements. Governing regulations, for example, truth-in-lending, provide for the imposition of significant monetary penalties. The auditor should recognize these possibilities and their potential adverse effect on the financial statements.

47. The auditor's tests of transactions and balances, study and evaluation of internal accounting controls, and tests of compliance may uncover unauthorized transactions, improperly recorded transactions, or transactions not recorded in a complete and timely manner. The auditor should also inquire of management about the possible existence and disclosure of contingencies arising from violations of relevant laws and regulations.

48. Should a violation or series of violations come to his attention,

the auditor is presented with two responsibilities. First, the auditor should evaluate the effect of the violation on the financial statements. Second, the auditor should inform credit union officials of the nature and extent of the violation. If the amount is determined to be material, it should be reflected or disclosed in the financial statements. The auditor should report the circumstances to appropriate personnel with respect to—

- Consideration of remedial action to be taken.
- Adjustments or disclosures necessary in the financial statements.
- Disclosures that may be required in other documents.

49. As a result of the discovery of a material violation that has not been properly accounted for or disclosed in the financial statements, the auditor should either qualify his opinion or express an adverse opinion because of the departure from generally accepted accounting principles. If the auditor concludes that the effect of a violation on the financial statements cannot be reasonably estimated, the auditor should consider modifying the audit report.

CHARTER, BYLAWS, AND MINUTES

50. The NCUA issues charters for federally chartered credit unions and prescribes the form of bylaws of such credit unions. For state-chartered credit unions, the appropriate state regulatory authority establishes the form of the charter and bylaws.

51. The auditor should review the charter and bylaws. The audit program may include procedures to determine compliance with charter and bylaw provisions that may have a material effect on the financial statements.

52. The auditor should read the minutes of the meetings of the board of directors, credit committees and/or loan officers, and other committees, noting items that have an effect on internal accounting controls and the financial affairs of the credit union. The auditor should observe that the minutes have been approved and that all material transactions discussed therein have been executed in accordance with the minutes.

53. The board of directors' minutes generally include approvals of such matters as loans charged off, transfers to and from retained earnings, purchases and sales of investments, major purchases and sales of property and equipment, borrowing arrangements, authorization and designation of terms of certain types of savings accounts, and rates on savings accounts.

54. Important transactions or matters requiring action by the directors or the members that are not covered in the minutes should be called to management's attention so that necessary approvals may be secured.

AUDITORS' REPORTS

55. The types of reports to be issued are based on the scope of services required by the credit union. The auditor should establish an understanding with the credit union, preferably in writing, regarding the services to be performed. The following are some typical services the auditor may be engaged to perform:

- Reporting on the financial statements of the credit union
- Assisting the supervisory committee in fulfilling its responsibilities by performing agreed-upon procedures
- Reporting on internal accounting control

56. The auditor's standard report on the financial statements of a credit union is the same as that used for other business enterprises.

57. An auditor may be involved with information other than the financial statements. SAS No. 27, *Supplementary Information Required By The Financial Accounting Standards Board*, paragraphs 4 and 5, state:

> The objective of an examination of financial statements in accordance with generally accepted auditing standards is the expression of an opinion on such statements. The auditor has no responsibility to examine information outside the basic financial statements in accordance with generally accepted auditing standards. However, the auditor does have certain responsibilities with respect to information outside the financial statements. The nature of the auditor's responsibility varies with the nature of both the information and the document containing the statements.
>
> The auditor's responsibility for other information not required by the FASB but included in certain annual reports—which are client-prepared documents—is specified in [SAS No. 8], *Other Information in Documents Containing Audited Financial Statements*. The auditor's responsibility for information outside the basic financial statements in documents that the auditor submits to the client or to others is specified in [SAS No. 29], *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*. The auditor's responsibility for supplementary information required by the FASB is discussed in [SAS No. 27, *Supplementary Information Required by the Financial Accounting Standards Board]*.

58. SAS No. 42, *Reporting on Condensed Financial Statements and Selected Financial Data*, provides guidance on reporting in a client-prepared document on condensed financial statements and selected financial data that are derived from audited financial data.

59. An auditor may be engaged to perform only specified procedures, such as confirmation of members' accounts. If so, the auditor should issue a special report in conformity with SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*, which requires that distribution of the report be restricted.

60. A credit union may request an auditor to report on a study and evaluation of the credit union's system of internal accounting control,

either in conjunction with an audit or as a special study. SAS No. 30, *Reporting on Internal Accounting Control*, provides guidance for such a report.

REGULATORY ACCOUNTING PRACTICES

61. Occasionally, the auditor may encounter regulatory accounting practices that differ from generally accepted accounting principles. Some of the more common variances are as follows:

- Accounting records maintained on a modified cash basis
- Entry of NCUA guaranty amount to guarantee asset losses
- Regulatory requirements to classify savings (shares) as equity
- Acceptability of settlement date accounting for investment securities
- Dividends on savings accounts not reported as expense
- Provision for loan losses not reported as expense

62. If variances from generally accepted accounting principles are material in amount, the auditor should qualify his opinion or give an adverse opinion. The auditor's report should refer to the variance specifically and should give a clear explanation of the nature of the modifications and the effect of the variance, if determinable, on the financial condition, results of operations, and changes in financial position. The auditor should refer to sections 544.02 and .04 of SAS No. 1, which provide guidance on reporting on regulated companies; SAS No. 14, *Special Reports;* and sections 509.15 through .19 of SAS No. 1, which deal with reporting if there has been a departure from a generally accepted accounting principle.

Chapter 3

CASH

63. Cash generally includes cash on deposit in other depository institutions and cash on hand.

64. Cash on deposit includes balances on deposit in banks and deposits in transit. These amounts may or may not be subject to withdrawal by check and may or may not be interest bearing.

65. Cash on hand consists primarily of a change fund and petty cash funds. A credit union's change fund is a supply of currency and coins used to cash checks, make savings withdrawals and loan disbursements, cash savings bonds, and make change. The fund often comprises the tellers' working funds, a reserve fund kept in the vault, or vault funds in transit. It may also include a currency supply for automated teller machines. Each teller should be individually responsible for the funds in his or her possession, but supervisory personnel should control the vault reserve fund.

FINANCIAL STATEMENT PRESENTATION

66. It is generally unnecessary to distinguish among the various elements included within the "cash" caption; therefore, the financial statement caption for cash includes deposits in banks, deposits in transit, cash items, or cash on hand. However, cash not subject to immediate withdrawal or restricted in some other manner should be properly disclosed and may need to be segregated in the statement of financial condition.

AUDITING

Objectives

67. The significant audit objectives for cash are to consider whether the balances are fairly stated in conformity with generally accepted accounting principles and whether cash items held will clear in the normal course of business.

Procedures

68. Cash is a significant item to a credit union because of the large volume of cash receipt and disbursement transactions. Most cash receipts result from savings deposits and payments on loans. Cash disbursements consist primarily of savings withdrawals, loan disbursements, and operating expenses. The nature of these transactions makes the teller the originator of a significant portion of the daily cash accounting entries. Thus, the principal documents tested by the auditor are cash received vouchers, checks used for disbursement purposes, and journal vouchers affecting cash. Typical audit procedures include the following:

- Count cash
- Control undeposited receipts
- Test bank reconciliations
- Test interbank transfers
- Review cash over and short summaries
- Test tellers' proof sheets
- Test control of mail receipts
- Test propriety of authorized accounts and signatures
- Reconcile subsidiary ledgers to general ledger
- Confirm account balances

69. In addition, the auditor should be alert to the presence of consigned items, a category that includes traveler's checks, money orders, savings bonds, and similar items. Positive confirmation from the consignors should be considered. The internal accounting control over supplies of consigned items should be studied and evaluated during the audit to determine the nature and extent of substantive testing.

70. Internal accounting control considerations for cash are listed in Appendix B of this guide.

Chapter 4

INVESTMENT SECURITIES

71. The management of credit union funds allows alternatives in the choice of assets, with the investment objective being an optimum balance of credit quality, liquidity, and income. This objective is attained through the investment portfolio, which is the credit union's second most significant asset after loans (see the discussion of loans in chapter 5).

72. Liquidity of the investment securities is an important consideration in the credit union's portfolio, for liquidity is required to meet normal, anticipated withdrawals of deposits, to provide a margin of safety for unforeseeable withdrawals, and to meet the members' credit needs. Furthermore, securities may be required to be pledged to guarantee the collectibility of certain government deposits or as collateral for borrowings.

73. The auditor should be aware of the effect of federal and state regulations on credit union investment decisions, particularly those restricting the types of investments available to credit unions, which are generally limited to the following:

- U.S. Treasury obligations, such as Treasury bills, notes and bonds
- Obligations and instruments of any agency of the United States
- Mortgage-backed securities issued or fully guaranteed by an agency of the United States
- Common trust or mutual investment funds approved by appropriate regulatory authorities
- Stock in the Central Liquidity Facility
- Investment deposits in any federally insured financial institution
- Investments in or loans to other credit unions
- Other investments, as outlined in section 107 of *The Federal Credit Union Act* or similar state statutes

74. The following are currently *unauthorized* (prohibited) investment activities for a federal credit union:

- Standby commitments to purchase or sell a security
- Futures contracts
- Adjusted trading or short sales
- Yield-maintenance contracts
- Pair-off transactions (matching or netting of commitments to purchase and sell securities via cash forward agreements)
- Common stocks
- Corporate debt obligations
- Equity participation in commercial real estate projects

75. The auditor should be aware of any limitations imposed by a state, which may or may not include the above items or which may include other limitations.

ACCOUNTING

76. Some credit unions traditionally record the purchase and sale of investment securities and the effect of transactions and valuation adjustments on the settlement date. Others record such transactions on the trade date. Trade date accounting is the proper method and settlement date accounting, which is the prevalent practice in credit unions (see "Regulatory Accounting Practices" in chapter 2), is acceptable only if the reported amounts would not be materially different.

77. If investment securities are held to maturity, they will generally be redeemed at face value; therefore, they are carried at amortized cost. If credit unions have the ability and intent to hold these securities on a long-term basis, credit unions do not customarily provide for unrealized declines in their value resulting from interest rate fluctuations.

78. Because it may be necessary to dispose of securities in the foreseeable future to meet the credit union's investment objectives or other operational needs, an allowance for estimated losses should be established to provide for a decline in the securities' value if (a) credit union management intends to dispose of a part of its investment securities portfolio in the foreseeable future or (b) the credit union is unable to hold a portion of its investment portfolio to maturity.

79. An allowance also should be provided if there is a market decline that is attributable to specific adverse conditions for a particular security unless persuasive evidence exists to support the carrying amount.

80. The related provisions for these allowances for estimated losses should be charged to earnings and classified in the income statement with securities gains and losses. If subsequent events prove that the conditions precipitating the origination of the allowance were only temporary in nature, the allowance should be reduced or eliminated. In no event should securities be valued in excess of cost.

Premiums and Discounts

81. Investment securities are generally acquired at a premium, a price in excess of face value, or at a discount, a price less than face value. A premium paid for a bond at the time of original issuance or at some time thereafter represents a downward adjustment of the stated rate of interest to reflect the market yield at the time of purchase. Conversely, a bond discount represents an upward adjustment of the stated rate of interest to the market yield at the time of purchase. The carrying amount of the bond during the

holding period is systematically adjusted to the amount anticipated to be realized at the maturity date. Amortization of premium or accretion of discount results in a reflection in the income statement of a yield that approximates the market yield at purchase date.

82. The entry to record the amortization of premium requires a debit to interest income with a corresponding credit to the investment asset or accumulated amortization account, which is netted against the asset account on the statement of financial condition. The reverse entry is used to record discount accretion. Accretion of bond discount and amortization of bond premium are based on the assumption that the face amount of the investment will be realized at maturity or at a call date.

83. The period of amortization or accretion is from the purchase date to the maturity date, except for securities purchased at a premium carrying an early call date at a price higher than par. The premium for these securities should be amortized to the maturity date or to an earlier call date. Premiums or discounts related to such securities as Government National Mortgage Association (GNMA) modified pass-through certificates should be systematically amortized or accreted over the estimated average life of the contract.

84. The two prevalent methods of amortizing premium or accreting discount are the interest method as defined in APB Opinion No. 21, *Interest on Receivables and Payables*, and the straight-line method.

85. The interest method of amortizing or accreting premium or discount recognizes an amount in earnings each month that produces a constant yield equal to the market yield at the date of purchase. When this method is used, the total amount of accreted discount added to the book value of the security by the end of each month increases each month; therefore, the amount of accretion credited to earnings also increases each month so that a level yield is reported. Conversely, the total amount of premium amortization deducted from the book value of the security by the end of each month increases each month; therefore, the amount of amortization charged to earnings increases each month so that a level yield is reported.

86. Straight-line accretion of discount or amortization of premium results in equal periodic adjustments to earnings from the time of purchase to the maturity date or earlier call date. The method has the advantages of being simple to compute and affecting earnings each month by the same amount. However, since the book value of the security is increased or decreased monthly by the amount of accretion or amortization reflected in monthly earnings, the book yield on the security decreases or increases each month.

87. The accretion of discount or the amortization of premium should be recorded in a manner that produces a constant rate of return on the basis of adjusted book value (interest method). However, straight-line or other methods of amortization or accretion may be used if the results obtained do not vary materially from those that would be obtained by the interest method.

Securities Gains and Losses

88. A credit union realizes gains and losses as the result of sales, early redemptions, and exchanges of investment securities. The recognition of discount gains and premium losses at maturity is eliminated for financial reporting purposes if bond premiums are amortized and discounts accreted. On securities sold before maturity, the gains and losses, even after adjustment for accreted discount and amortized premium, can be significant.

89. Previously unrecognized securities gains and losses should be recognized on the completed transaction basis; that is, the gains and losses should be recognized on the trade date for financial reporting purposes.

90. The amounts invested in investment portfolios in many credit unions may fluctuate with changes in savings account levels and loan demand. The fluctuation may result in substantial buying and selling of investments. When funds are in ample supply, securities prices tend to be high and yields comparatively low. At those times many credit unions buy securities in order to make productive use of available cash. Conversely, when funds are scarce, securities prices tend to be low. The demand for funds may cause credit unions to sell securities at substantial losses to satisfy loan demand and, on occasion, to meet savings account withdrawals. The transactions may produce substantial securities gains or losses.

91. If there is substantial turnover in the investment portfolio, management's intention and experience determine whether a trading function is occurring and the appropriate classification and valuation method to be used.

Troubled Debt Restructuring

92. Accounting and reporting requirements for securities that have been involved in troubled debt restructurings (including instances in which the substitution of debtors is primarily a matter of form) are set forth in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*.

FINANCIAL STATEMENT PRESENTATION

93. Disclosure of the market value of investment securities, either in the statement of financial condition or in the notes to the financial statements, helps a reader of the credit union's financial state-

ments to evaluate the potential earning power of those investments, since the potential earning power is governed by prevailing market interest rates applied to the estimated market value and not by the book value of the credit union's invested assets. Market value should be disclosed.

94. Securities that are pledged for bank borrowing or other purposes should also be disclosed in the financial statements.

95. A credit union may loan cash to a member bank of the Federal Reserve System. Such loans are commonly referred to as *federal funds*. Ordinarily, such loans are for one day only, with the lending credit union regaining its funds on the business day following the loan. If material, the amount of such loans should be classified separately in the financial statements.

96. A credit union may invest in short-term repurchase agreements, commonly referred to as *repos*. These transactions represent purchases of securities on a short-term basis under agreements whose terms provide that the sellers will repurchase the securities within a short period of time, usually a few days. If material, these investments should be classified separately in the financial statements.

97. A credit union may also borrow under fixed coupon-repurchase agreements, commonly referred to as *reverse repos*. In substance, these arrangements represent borrowings collateralized by the related securities. When funds are borrowed under this arrangement, a liability should be established for the amount of the proceeds. The investment security account should not be relieved of the collateral securities. Interest on reverse repos should be reported as an expense and not shown net of interest income.

98. Losses not previously recognized and gains from securities transactions should be recorded in the statement of income for the period in which securities are sold or otherwise disposed of.

AUDITING

Objectives

99. The significant objectives of tests of a credit union's investment securities are to obtain reasonable assurance that —

- The physical securities are on hand or held in custody for safekeeping by others for the account of the credit union.
- Interest and dividend income and securities gains or losses have been recorded properly.
- Investments and the related income, gains, and losses are fairly presented in conformity with generally accepted accounting principles in the financial statements, including disclosure of amounts pledged and market value.
- Investments have not suffered a permanent reduction in recoverable value, and allowances for losses have been provided where necessary.
- Investments comply with federal and state regulations.

100. The auditor should be familiar with an auditing interpretation titled *Evidential Matter for the Carrying Amount of Marketable Securities* (*AICPA Professional Standards*, vol. 1, AU sec. 9332, January 1975). This interpretation provides guidance on the evidence the auditor should obtain pertaining to classification and carrying value of marketable securities, including —

- Reasons for and evidence of the market decline when market value is below cost and evidence of whether the market decline is temporary or reflects more persistent conditions.
- Management's estimates of the outcome of future events.
- The credit union's financial position requirements for operating funds, and any contractual obligations, or other requirements that could affect the credit union's ability to hold the securities. For investments in bonds and other investments with fixed maturity amounts, market declines may be considered temporary unless the evidence indicates that such investments will be disposed of before they mature or that they may not be realizable.
- Management's representation regarding its intent in the credit union's representation letter. The auditor should read the minutes of the board of directors meetings and should inquire of the investment committee concerning management's intentions on disposing of the securities.

101. If securities that will be disposed of in the foreseeable future have a market value lower than their carrying amount, the auditor should obtain persuasive evidence that a recovery in the market value will occur before the securities' maturity or sale date, whichever is earlier, or within a one-year period from the statement of financial condition date. Generally, such evidence would be limited to substantial recovery subsequent to the year end. If there is no evidence to support the carrying amount, and management has not established an allowance for the amount of the writedown to market value, the auditor should consider the need to modify the audit report for a departure from generally accepted accounting principles.

102. If securities not to be disposed of in the foreseeable future have a market value below cost, the auditor should consider the credit union's ability to recover the carrying value and should obtain persuasive evidence supporting the carrying amount. An allowance should be provided if there is a market decline that is attributable to specific adverse conditions for a particular security unless persuasive evidence exists to support the carrying amount. If the decline in market value is attributable to general market conditions, an allowance need not be established by management unless there is evidence that the carrying amount will

not be recovered. If any required allowances are not established by management, the auditor should consider the need to modify the audit report for a departure from generally accepted accounting principles. The auditor should consider whether available information does not support a judgment regarding eventual recovery or a contrary judgment that recovery will not occur. In such a situation, the auditor should consider the need to modify the audit report.

Procedures

103. Securities owned by the credit union at the audit date should be examined or confirmed directly with custodians of securities pledged by or held for the account of the credit union. In addition, the auditor should determine that registered bonds and stock certificates are registered in the name of the credit union or held for safekeeping and that all unmatured coupons are intact and matured coupons have been clipped.

104. The auditor should consider whether the testing of investments is properly coordinated with that of other negotiable items, such as cash, collateral held by the credit union as security for loans to members, and consigned items.

105. The board of directors is responsible for investment policies for credit union assets, with management authorized to make investment decisions in accordance with the board's policy. The auditor often tests compliance with this internal accounting control policy by noting the following:

- Types of transactions
- Authorized employees transacting investments
- Authorized broker-dealers
- Periodic reporting to the board
- Safekeeping
- Surety bonds

106. Internal accounting control considerations for investment securities are listed in Appendix B of this guide.

Chapter 5

LOANS

107. Loans are generally the largest asset of a credit union and may be classified as follows:

- Consumer loans
  - Collateralized loans (for example, automobiles, mobile homes, boats, household furnishings)
  - Unsecured loans
    - Signature loans
    - Lines of credit
    - Credit card loans
- Real estate mortgage loans
- Other loans
  - Loans collateralized by savings accounts
  - Agricultural loans
  - Business loans
  - Education loans

108. A credit union is chartered to originate loans to its *members*. Regulations further impose maximum limits to individual borrowers and prescribe restrictions for lending to insiders.

CONSUMER LOANS

Collateralized Loans

109. A significant type of consumer (installment) loan in a credit union is one secured by personal property. The board of directors generally establishes lending policies that are administered by the credit committee or the loan officer and that cover the following areas:

- Maximum maturity of the loan
- Market value of security in excess of loan value
- Down payment requirements
- Hazard insurance with credit union named as loss payee
- Types of personal property accepted as collateral
- Lien recordation (accompanied by security agreement or financing statement)
- Financial condition of borrower
- Employment history of borrower

Pledged collateral may include the following items:

- Automobiles
- Mobile homes
- Household furnishings
- Assignment of land sales contracts
- Cash value of life insurance policies
- Marketable stocks and bonds
- Loans with cosigners or guarantors

110. The installment loan typically is structured for repayment in equal monthly payments, with interest computed at a contractual interest rate on the outstanding balance. A loan may be cosigned by a third-party or guaranteed by a third-party or by a government agency. Maturity of an installment loan generally depends on the nature of the loan and on the type of collateral.

Unsecured Loans

111. A common form of lending in credit unions is the unsecured signature loan, in which the bor-

rower's obligation is evidenced only by an executed note. A credit union is responsible for implementing its own underwriting policies, which involve guidelines for investigating the following information about the borrower:

- Employment history
- Financial statement
- Credit report
- Loan application

112. In addition to the traditional unsecured signature loan, a credit union may grant a loan under a self-replenishing line of credit. The open-end, self-replenishing line-of-credit loan requires the borrower to complete the loan application and approval process only one time, except for periodic updating. The borrower may increase his outstanding loan balance up to a preapproved limit through the following:

- Check or cash disbursements
- Automated teller machine loan disbursements
- Loans to clear share overdrafts
- Loan draft disbursements

113. The line of credit is replenished by required minimum monthly payments. The line-of-credit agreement may be cancelled upon notice by either party, but this notice does not relieve a borrower from the obligation to repay funds borrowed under the agreement prior to its cancellation.

114. Another form of unsecured lending for credit unions is through the use of a credit card. The credit union may do the following:

- Issue the card, process the transactions, and assume the loan risk.
- Contract with a service company to issue the card in the credit union's name, allow the service company to process the transactions, but retain the loan risk.

115. After a credit card has been issued to a member, thereby establishing a line of credit, loan transactions are initiated by the member's purchase of goods or services from a participating merchant. The merchant submits the charge slips to his or her financial institution and receives credit for the amount of the transaction, less a negotiated discount. The charge slips are then processed and charged to the card holder's account. The card issuer receives a portion of the fee paid by the merchant to his financial institution for processing the charge slips.

116. The card holder normally receives a monthly statement. The entire account balance may be paid without interest, or the card holder may pay a portion of the balance and monthly interest computed on the outstanding balance in accordance with the credit union's policy.

117. Certain features of credit card operations warrant emphasis. Since the transaction is initiated through the use of an identification card, issued and unissued cards should be controlled to prevent fraudulent use. Theft of cards at the processing or delivery stage or after receipt by the card holder, represents a significant risk of loss to a credit union. Merchants are generally required to obtain prepurchase authorization for purchases in excess of a specified amount. Credit unions monitor accounts with high balances, excessive activity, and delinquencies to lessen the possibility that inappropriate use of credit by the cardholder will result in losses. In an effort to minimize losses resulting from fraudulent use of stolen cards or extension of credit to holders of terminated cards, credit unions regularly notify their agents of card numbers that are not to be honored.

118. Credit unions also offer other forms of revolving or open-end credit that are marketed under various programs and may include loan drafts related to their share draft plans.

REAL ESTATE MORTGAGE LOANS

119. Credit unions originate real estate loans to members *only*. These loans are generally secured by first or second mortgages and may extend for a period of up to forty years. In granting real estate loans, credit unions generally use forms developed jointly by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). Repayment terms customarily require monthly payments of principal and interest. Certain mortgage loans may be priced on a variable rate or other repayment basis. The monthly payment often includes an amount to be held in escrow for the payment of real estate taxes and insurance.

120. In addition, credit unions may grant loans to finance construction. Construction loans generally are granted only after the borrower has arranged for long-term financing upon completion of construction (a takeout commitment). Although usually secured by real estate, construction loans generally entail more risk than real estate loans on improved property. Internal accounting controls over construction loans include documentation requirements for advances of funds and periodic on-site inspection of the property.

121. Real estate mortgage loans should be made on the basis of a percentage of the appraised value of the mortgaged property at the time the loan is granted. In periods of increasing property values, an expansion of lending activity may occur in the form of subordinate mortgages (second liens or second trusts).

122. The NCUA's *Credit Manual for Federal Credit Unions* recommends that each real estate loan file should contain —

- A loan application that reveals the amount of credit requested, the purpose of the credit, and the applicant's signature.
- The signature and approval notations of the credit committee or the loan officer.
- Current financial statements.
- Documentation by the credit

committee or the loan officer of the analysis of the loan application, including verification of deposits and employment.

- Appraisal reports by a qualified appraiser.
- Evidence of clear title from a title insurance policy or attorney opinion.
- A real estate note that is properly executed and recorded.
- Evidence of current hazard insurance sufficient to pay the mortgage balance, with a standard mortgage clause in favor of the credit union.

123. Additionally, documents may be required by other federal and state regulations. These documents may include truth-in-lending disclosures, settlement statements, notices of recision, statement of flood insurance requirements, and applicable government agency guarantees.

124. Collateral records typically are maintained, either as part of the detail loan record or in separate files, indicating the current status of pledged collateral. When the loan has been paid or when collateral is withdrawn or substituted, the borrower acknowledges the release of the collateral by signing a collateral release, a copy of which is retained by the credit union.

OTHER LOANS

Loans Collateralized by Savings Accounts

125. Credit unions often make loans secured by savings accounts. The promissory note for such a loan usually provides for assignment of the savings account to the credit union, and it normally entitles the credit union to withdraw funds from the account to pay off the loan balance and accrued interest if the borrower defaults. Credit union management should establish a system to restrict access to assigned savings accounts to prevent unauthorized withdrawals. Furthermore, pledged savings accounts should clearly indicate the collateral withdrawal restrictions.

Agricultural Loans

126. Agricultural loans may be secured by farm machinery and equipment, livestock, or crops. These loans require special knowledge of farm operations and may involve the following underwriting considerations:

- Existence of prior liens or security interests
- Equity or down payment amounts
- Seasonal nature of farm operation
- Insurance coverage
- Financial condition of borrower

Business Loans

127. A business loan normally is secured by the assets of the borrowing organization, and the proceeds of the loan generally are used to acquire a business or business assets or to finance the operation of a business.

Education Loans

128. Credit unions must apply to the appropriate insuring agency for a contract or authorization to make insured student loans. Credit unions may also sell or pledge insured student loans to the Student Loan Marketing Association (Sallie Mae). The terms and underwriting provisions are subject to the policy of the insuring agency.

ACCOUNTING

129. The general ledger control accounts should be supported by subsidiary records, which may consist of manually or machine-posted ledger cards or computer-prepared listings. A single subsidiary record may contain all pertinent information relating to a loan, including escrow balances for real estate loans, interest rate and loan payment status for installment loans, and the amount of monthly payments. Conversely, it may be necessary to refer to a number of separate records to obtain all necessary loan information.

130. Credit unions may carry a *loans-in-process* account that represents the undisbursed portion of mortgage loans. This account should be supported by a subsidiary ledger containing an individual account for the undisbursed portion of each mortgage loan.

131. Some credit unions maintain ledgers in which all members' liability transactions are posted. The ledger presents the cumulative total of all borrower liabilities, including direct and indirect liabilities as maker, endorser, or guarantor. The ledger provides a readily available source for obtaining information relating to an individual member's total commitment to the credit union.

132. Interest income on loans normally is credited to operating income, based on the outstanding principal amount of the loans. Federal credit unions are precluded from using the Rule of 78s to compute interest on loans and the auditor should determine if similar state restrictions exist, if appropriate. Interest may be calculated and collected on either a 360- or 365-day basis per year. The auditor should be alert to a credit union's policy of permitting grace periods for payments since some credit unions, to ease the task of computing interest, may not assess additional interest or late charges for a short period following a due date.

133. A credit union may suspend accrual of interest income on a loan when the payment of interest has become delinquent or collection of the principal has become doubtful. Such action is prudent and appropriate. Regulatory guidelines for nonaccrual loans have been established by supervisory agencies.

134. Although placing a loan in a nonaccrual status, including loans accruing at a reduced rate, does not necessarily indicate that the principal is uncollectible in whole or in part, a re-evaluation of collectibility

of principal and previously accrued interest generally is warranted. If amounts are received on a loan on which the accrual of interest has been suspended, a determination should be made about whether the payment received should be recorded as a reduction of the principal balance or as interest income.

135. If the ultimate collectibility of the principal, wholly or partially, is in doubt, any payment received on a loan on which the accrual of interest has been suspended should be applied to reduce principal to the extent necessary to eliminate such doubt.

Loan Origination Fees

136. The AICPA has formed a task force (1) to study accounting by all financial institutions for loan origination and commitment fees and initial direct costs and (2) to prepare an issues paper addressing the diversity in practice. When this guidance is issued, the auditor should consult it for these types of transactions.

Credit Card Fees

137. Some credit unions charge a periodic fee to credit card holders. Such fees, when material, should be deferred and amortized over the term to which the fee relates.

Loan Participations, Sales, and Purchases

138. Federal credit unions may —

- Purchase, sell, or pledge, to any source, eligible loans of its members.
- Purchase eligible loans of a liquidating credit union's members.
- Originate or take part in the granting of participation loans.
- Purchase members' student loans from any source.
- Purchase members' real estate loans from any source.

139. The last two items are intended to facilitate the packaging of a pool of loans for sale or pledging in the secondary market. Federal or state regulations may prescribe an overall limit of purchase loans, such as the 5-percent limit of regulatory capital for federal credit unions.

140. Servicing arrangements generally provide for the servicing credit union to maintain all records related to the servicing agreement, to assume responsibility for billing mortgagors and collecting periodic mortgage payments, and to perform all other activities necessary to the mortgage servicing function.

141. Serviced loans may be originated by the servicing credit union itself or by other financial institutions. Loans originated by the servicing credit union may be sold, in whole or in part, to investors, but the servicing activities are retained by the seller credit union. In any of the foregoing arrangements, the credit union receives as compensation a servicing fee, normally expressed as a percentage of the principal balance of the outstanding loans.

142. A credit union occasionally may sell loans at servicing fee rates significantly different from current rates. FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, sets forth the recommended accounting treatment for loans sold at a servicing fee rate significantly different from current rates. The statement concludes that an adjustment to the sales price is required whenever the effect on operating results is significant. Such adjustments would result in deferred amounts, to be amortized to servicing fee income over future years. In addition, if current servicing fees are expected to be less than estimated servicing costs over the estimated life of the mortgage loans, the expected loss on servicing the loans shall be accrued at that date.

143. Gains or losses are usually recognized at the time the loans are sold. However, if at the end of a reporting period it is apparent that a credit union intends to sell certain loans and that the anticipated sale will result in a loss, the credit union should establish an allowance for losses, which is deducted from the related asset in the statement of financial condition.

144. In accounting for sales of loans or participations, the objectives are to recognize in the year of sale the economic gain or loss from the transaction and to avoid including in the year of sale income or expense attributable to a future period. Consequently, when loans are sold outright and are not to be serviced by the selling credit union, the gain or loss is measured by the difference between the selling price and the carrying amount of the loans sold (less applicable deferred loan fees, if any). If loans sold are to be serviced by the selling credit union, adjustment of the selling price to provide a current servicing fee may be required (as discussed earlier in this section).

145. Because of the variety of arrangements under which loan participations are sold, it is important to consider, in addition to the stated selling price, the terms of sale, the effective yield to the purchaser, and the arrangements for servicing. A premium or a discount may result when a participation is sold at a price equal to the carrying amount of the loans included in the participation sale and the seller agrees to pay the purchaser a rate of interest greater or less than the loan's stated rate of interest. In such cases the premium or discount should be represented by the discounted amount of the difference between the future interest to be collected by the seller and the interest to be paid to the purchaser after considering future servicing revenues and costs.

146. The principles and guidelines set forth in APB Opinion No. 21 apply to premiums and discounts. The opinion sets forth the method of amortization and financial statement presentation and disclosure.

FINANCIAL STATEMENT PRESENTATION

147. Loans historically have been presented in the statement of financial condition in an aggregate amount. Note disclosures should include a breakdown of loans by major types of lending activities. Consideration should also be given to the need for note disclosure of other information, such as maturities for significant categories of loans and the amounts of loans at fixed rates of interest and at floating rates of interest. Each credit union's share of a participation loan should be classified according to the major type of lending activity represented by the loan.

148. Share draft overdrafts, if material, should be classified as loans.

149. Credit unions may also include in their financial statements —

- The undisbursed portion of mortgage loans deducted from the related loans and disclosed either in the statement of financial condition or in the notes.
- Accrued loan interest receivable presented in the caption "Other Assets" or as a separate category of assets.
- Allowances for loan losses and unamortized loan origination and commitment fees, which represent an adjustment of yield deducted from related loan balances. Other unamortized loan fees, if material, should be presented as other liabilities.
- The principal amount of nonaccrual loans disclosed, if material, in the notes.
- Loans to officials and employees, if material, in the notes. The terms of such loans should also be disclosed if such loans were made on other than normal business terms. In addition, the credit union should consider the need to disclose information on loans to organizations with which officials and employees are affiliated. FASB Statement No. 57, *Related Party Disclosures*, establishes requirements for related party disclosures.

AUDITING

Objectives

150. Certain significant audit objectives are common to all types of loans and include obtaining evidential matter to support the assertions that —

- Loan balances are reasonably stated as of the date of the financial statements under examination.
- The allowance for loan losses is adequate to provide for reasonable anticipated losses (see chapter 6).
- Income and related accrued interest receivable and deferred discount (unearned discount) are stated in conformity with generally accepted accounting principles.
- Loans are owned by the credit union.

Procedures Common to All Types of Loans

151. The auditor reviews lending policies and inspects documents supporting loans. Specifically, the auditor selects a sample group of loans from all significant loan categories and performs detailed tests on them. Although larger loans are commonly emphasized, a sample that is selected should be representative of the loans granted by the credit union. The tests normally include inspection of the executed notes, loan applications, financial statements of borrowers, and other credit information and supporting documentation appropriate to the types of loans being examined. The auditor should check for appropriate approvals contained in the loan files and records of the loan officer and in minutes of the meetings of the board of directors or credit committee. Regulations for loans to officials may require approval by the board of directors.

152. After the underlying subsidiary loan records are balanced with the general ledger control accounts, the auditor should request confirmation of a representative sample of loan balances directly with the borrowers. Negative confirmations are often used if loans involve a large volume of individually immaterial balances and if the auditor considers internal accounting control surrounding such loan accounts to be effective. Positive confirmation procedures are used for larger loans and for loans that require confirmation of information, such as amount and type of collateral and amount of escrow deposits, in addition to the loan balance. (Sections 331.03 through .08 of SAS No. 1 provide guidelines for the use of confirmations.)

153. The results of the detailed inspection of a sample group of loans assists the auditor in determining that loans actually exist. To evaluate the collectibility of loans, the auditor should perform separately designed tests. (See chapter 6.)

154. The audit often includes procedures to test compliance with credit union policies relating to loans charged off. The loan file should include documentation indicating the following:

- Approval of the charge-off by the board of directors
- Collection history of the loan
- Disposition of collateral
- Correspondence with borrower

155. Accrued interest receivable and interest income are often tested for a representative sample group of loans. Audit procedures should include recalculation of accrued interest, balancing of subsidiary records to the general ledger control accounts, and testing of interest income for a selected period. The auditor should also test interest income overall by relating income for the period under examination to the average loan balance by type of loan and comparing the resulting yield to interest rates in effect during the period. Confirmation requests may include appropriate information relating to accrued interest receivable, interest rates in

effect as of the confirmation date, and collateral.

156. The auditor should normally review loans to officials and employees as well as loans to organizations with which these individuals are affiliated. The auditor may correlate information developed through other audit tests with reports of federal and state supervisory agency examiners and with records maintained by the credit union relating to potential conflicts of interest. Such credit union records may include summaries of the business interests of officials and employees.

Procedures for Specific Types of Loans

157. *Collateralized loans*. The auditor should test the physical existence and proper assignment to the credit union of collateral supporting collateralized loans. The examination of loan documentation should include tests of the adequacy of both the current value of collateral in relation to the outstanding loan balance and, if needed, insurance coverage on the loan collateral. For loans involving guaranties, the auditor should normally read the financial statements and other evidence of financial condition of cosigners and guarantors and consider confirming with guarantors. Controls over collateral should be evaluated, with particular emphasis on controls surrounding negotiable collateral.

158. *Line-of-credit loans*. The auditor often performs the following tests of lending policies:

- Determine the frequency of review of established line-of-credit loan files.
- Determine whether maximum credit limits are established on the individual member's ability to pay.
- Review the board of directors' policies for advances that exceed an individual borrower's credit limit and for requests to increase that approved limit.
- Determine that collateral, if applicable, is pledged according to the board of directors' policy.

159. *Credit card loans*. If the credit union is involved in credit card operations, including credit card issuance and processing transactions, the auditor should study and evaluate the system of internal accounting controls to determine the degree of reliance, if any, to be placed on such controls. Procedures for the review of credit card operations depend on the degree of credit union involvement. A review of lending policies, confirmation of members' balances, and tests of interest and service charges, delinquencies, and charge-offs are appropriate.

160. *Mortgage loans*. The auditor's tests of mortgage documents frequently emphasize loans made since the date of the last audit, and they are supplemented by limited tests of documents relating to mortgage loans originated in prior periods. The auditor should consider coordinating confirmation of the unexpended balances of escrow funds and mortgage loan principal balances with borrowers. The activity in the escrow accounts should normally be tested. In addition, the auditor should review the procedures the credit union follows for determining that adequate fire and other hazard insurance coverage is carried, that real estate taxes are currently paid, and that properties are in good condition.

161. *Servicing*. SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*, provides guidance on the preparation and use of a special-purpose report on certain aspects of internal accounting control of an organization providing certain services to a client whose financial statements the CPA has been engaged to examine. The statement requires the CPA to consider the division of accounting and control functions between the client organization and the service organization.

162. *Loan participation*. The auditing procedures for participations in loans purchased are similar to those for direct loans, except that requests for confirmation of the balance of collateral, if any, are sent to the managing (lead) credit union. Loan files for participations should be available at the credit union and should contain pertinent documents (or copies), including credit files supporting loans in which it has purchased participations from other credit unions. Details for participations in a credit union's direct loans sold to other credit unions should be confirmed with the participating credit unions. Confirmation of the amount of each credit union's participation in the loans should be requested. However, care should be exercised in requesting confirmation of participations sold. Since the borrower normally deals only with the credit union originating the loan, the gross balance, including amounts sold to other credit unions, should be confirmed with the borrower.

163. Internal accounting control considerations for loans are listed in Appendix B of this guide.

Chapter 6

ALLOWANCE FOR LOAN LOSSES

164. The allowance for loan losses represents management's estimate of loan losses in a credit union's loan portfolio. If the allowance for loan losses is less than losses currently anticipated, the additional amount needed to increase the allowance should be recognized as a charge to operating expenses in the current period.

ACCOUNTING

165. A credit union should maintain a reasonable allowance for loan losses, applicable to all categories of loans, through periodic charges to operating expenses. The amount of the provision should be adequate to cover estimated losses inherent in the loan portfolio; that is, the propriety of the accounting treatment should be judged according to the adequacy of the allowance determined on a consistent basis, not the provision charged to operating expenses.

166. Loans should be written off when they are deemed uncollectible, and that practice should be applied consistently in all interim financial reporting periods.

FINANCIAL STATEMENT PRESENTATION

167. The allowance for loan losses that is accumulated through charges to operations should be deducted from the related assets in the statement of financial condition. The notes to financial statements should include a summary of activity in the allowance for loan losses account for the period.

AUDITING

Objective

168. The significant objective of the audit of the allowance for loan losses is to evaluate the reasonableness of the recorded allowance.

Procedures

169. As previously discussed, the allowance for loan losses represents an amount that, in management's judgment, approximates current amounts of loans that will not be collected based on all relevant conditions. The auditor's considerations should not be limited to previous collection experience but should also include estimates of the effects of changing business trends and other relevant factors. Care should be exercised to avoid reliance on, or emphasis on, mechanical formulas that incorporate only collection experience.

170. Evaluating the adequacy of the loan loss allowance involves considering loan collectibility, that is, whether the loan will be repaid or the principal otherwise recovered. The answer may depend on, among other factors, the borrower's financial ability as indicated in past and projected earnings and cash flow, credit and payment history, net realizable value of the loan collateral, and the financial responsibility of endorsers or guarantors. Most often a combination of these factors determines the soundness of a particular loan.

171. The auditor is responsible not for calculating the amount of the allowance but for obtaining evidence that management has recorded an adequate allowance, based on available information and all relevant factors bearing on loan collectibility.

172. Since loans generally are the credit union's largest single class of assets and present the highest potential for loss, the auditor may encounter a number of groups, in addition to state and federal supervisory agency examiners, that have an interest in evaluating the collectibility of the loan portfolio. Interested groups may include the credit committee, supervisory committee, internal auditor, and board of directors. The groups' specific responsibilities in loan review vary, depending on the size of the credit union and on the directives of the board of directors, the credit committee, and management. The auditor's testing is most efficient when it is designed to maximize the use of information available from these sources, and the auditor may consider their efforts when setting the nature, extent, and timing of tests.

173. In evaluating the reasonableness of the allowance, the auditor should consider the following:

- Current trend of delinquencies
- Loans classified by supervisory agency examiners
- Loans with excessive renewals and extensions
- Absence of current financial data relating to borrowers and guarantors
- Borrowers and guarantors experiencing such problems as operating losses, marginal working capital, and inadequate cash flow
- History of prior loan losses
- Loans secured by collateral not readily marketable or susceptible to deterioration in realizable value
- Loans to entities in industries experiencing economic instability
- Inadequately documented loans

174. If the auditor is to rely on delinquency reports, such as an aging of the loan balances by the degree of delinquency, the information in these reports should be tested to assist the auditor in determining the degree of reliance to be placed on them.

175. The auditor is not required to test individually the collectibility of each loan in a credit union's portfolio. The audit procedures should be designed to test the overall collectibility of the portfolio and should be performed primarily on selected loans. In establishing the

scope of the work to be performed, the auditor should consider the composition of the loan portfolio, current growth trends in specific loan classifications, previous loss and recovery experience (including timeliness of charge-offs), his potential reliance on internal accounting control for lending policies and procedures, management's procedures for loan review and classification, and such factors as economic and environmental conditions.

176. Although the auditor's primary responsibility when reviewing the allowance for loan losses is to evaluate its adequacy as a whole, practical considerations may dictate that the review be directed to the separate types of loans that constitute the credit union's portfolio. Since the risk and other inherent characteristics of primary loan categories vary, the nature and extent of the separate reviews can be expected to vary as well.

177. Loan categories represented by large volumes of relatively small loans with similar characteristics, such as installment loans and retail credit loans, generally are evaluated on a group basis. The auditor usually is more concerned with the effectiveness of, and adherence to, sound procedures related to such loans as a group rather than with a critical appraisal of each loan. Where controls are effective and unless unusual circumstances exist, the testing of procedures and review of delinquency status reports should permit a conclusion to be drawn about the adequacy of the allowance required for these loan classifications. In evaluating the adequacy of the portion of the allowance attributable to those loans, use of historical average annual charge-off experience should be considered in light of the average remaining lives of loans, consistency of loan policy, and current economic conditions.

178. In contrast, an evaluation of real estate and other large-balance loans normally requires a more detailed review. A relatively small number of potential losses can often significantly affect the adequacy of the allowance. The auditor may select and review a certain number of loans in excess of a specific amount, with particular attention to problem loans previously identified by the credit union's internal review procedures, the auditor's prior experience, and loans commented on by supervisory agencies. Loans selected for review may be further stratified by type of loan, depending on the auditor's assessment of the relative exposure to loss presented by the various categories.

179. The total amount, number, and types of loans reviewed, expressed as a percentage of the loan portfolio, will vary by credit union. In making such decisions, individual judgment, based on existing facts and circumstances, should prevail. Such factors as trends in the level of delinquent loans, local and general business conditions, past loss experience, and credit union lending and loan review policies should be considered case by case. With respect to the collectibility of members' loans, the auditor should be alert to the possible effect of announced plant closings, shutdowns, or layoffs by the common bond employer.

180. Audit procedures for the allowance for loan losses should also include testing of unused loan commitments, overdrafts, and accrued interest receivable.

181. For purposes of expressing an opinion on the financial statements, the auditor is concerned with the amount at which loans are stated in the aggregate. Therefore, the specific allowances identified with individual loans and groups of loans should be supplemented by an amount provided for inherent loan portfolio losses not specifically provided for. This amount should be based on judgments regarding risk of error in the specific allowance for individual loans and groups of loans, exposures existing in the credit union's loan portfolio, and other relevant factors consistently applied.

REGULATORY COMPLIANCE

182. For regulatory purposes, credit unions have historically used either the *experience method* or the *adjustment method* to calculate their allowance for loan losses. Although the application of either method may or may not result in substantially the same allowance as management's estimate for the loan loss allowance, management should report a loan loss allowance in the financial statements prepared under generally accepted accounting principles that is adequate to cover all estimated losses in the loan portfolio.

183. The NCUA's *Accounting Manual For Federal Credit Unions* describes these methods as follows:

> **Experience Method**
> Under this method, the amount needed in the allowance for loan losses is based on the credit union's loss experience and its average loan balances for the current year plus the five preceding calendar years and the average maturity of all loans outstanding.
>
> **Adjustment Method**
> The credit union will perform a review of all loans delinquent two months or more and loan derived assets to determine its best feasible estimate of potential losses which will be sustained in collection and as to the adequacy of the Allowance for Loan Losses. The estimate should be based on the best judgment of the credit union officials taking all pertinent factors into consideration, including loan delinquency status, collection experience of the credit union, unusual economic conditions that may affect collectibility, availability of endorsers, pledged shares and/or other collateral or security, insured FHA or educational loan coverage, and the general credit reputation of the borrowers.

Chapter 7

OTHER ASSETS

184. The following items may constitute other assets in a credit union:

- Property and equipment
- Real estate or other property acquired in satisfaction of members' loan obligations
- Accounts receivable
- Prepaid expenses (for example, prepaid membership dues, share insurance, and assessments)
- Payroll deductions receivable
- Investment in data service centers
- Investment in service corporations
- Investment in Central Liquidity Facility
- Monetary Control Reserve Deposits
- Accrued income accounts

ACCOUNTING

Property and Equipment

185. This category includes the following:

- Land
- Building
- Furniture and equipment
- Leasehold improvements
- Leased assets

Property acquired in satisfaction of members' loan obligations should not be included in property and equipment, but rather under the other assets caption.

186. Under section 107(4) of the Federal Credit Union Act, as well as many state statutes, credit unions are authorized to purchase, hold, and dispose of property necessary or incidental to their operations. Credit unions are limited by regulatory authorities to a maximum investment in property and equipment. They are also prohibited from acquiring real property from related parties.

187. Property and equipment should include all costs related to the acquisition of the property, including transportation and installation costs. If a credit union constructs property, cost includes all direct construction costs together with architects' fees, costs of excavations, and supervision of construction. FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, addresses the capitalization of property taxes and other carrying charges (excluding interest) incurred during construction. FASB Statement No. 34, *Capitalization of Interest Cost*, sets forth criteria for capitalization of interest. FASB Statement No. 13 provides guidance for accounting for properties subject to leases (either operating or capital).

188. Typical depreciation methods used by credit unions include the following:

- Straight-line
- Sum-of-the-years' digits
- Declining balance
- Composite

Sale and Leaseback Arrangements

189. In recent years a number of credit unions have entered into sale and leaseback transactions involving their operating facilities.

190. The following literature contains substantive accounting guidance:

- FASB Statement No. 13, *Accounting for Leases*
- FASB Statement No. 28, *Accounting for Sales with Leasebacks*
- FASB Statement No. 66, *Accounting for Sales of Real Estate*
- APB Opinion No. 21, *Interest on Receivables and Payables*

Other Assets

191. Credit unions may have equity investments in subsidiary companies generally described as service corporations. The amount of investment permitted in service corporations is governed by federal or state regulations. The financial statements of subsidiaries should be included in the consolidated financial statements in accordance with the provisions of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, and APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*.

FINANCIAL STATEMENT PRESENTATION

192. Property and equipment are normally shown as a single caption on the statement of financial condition, net of accumulated depreciation and amortization. However, if the individual categories of assets are material, separate captions should be used in the statement of financial condition or in the notes to the financial statements. In either case the basis of valuation should be indicated in the statement of financial condition or in the notes. Accumulated depreciation and amortization may be shown on the statement of financial condition as a separate item deducted from the related assets, parenthetically if the assets are reported at a net amount, or in the notes to the financial statements.

193. Lease commitments should be disclosed in the financial statements in accordance with FASB Statement No. 13 and its amendments and interpretations.

194. Appropriate information should be obtained for the total estimated cost of a major expansion program and for the unused amounts of related commitments. These commitments should be disclosed notes to the financial statements if the amounts are material.

195. Items classified as "Other Assets" may be presented as a single amount under that statement of financial condition caption. However, items that are individually material in amount should be presented separately under that caption. Items classified as "Other Assets" are generally presented last in the asset section of the statement of financial condition.

AUDITING

196. The audit objectives, internal accounting control considerations, and audit procedures for credit union property and equipment and other assets are similar to those for other business enterprises.

197. Typical audit procedures for property and equipment include the following:

- Examine supporting documents for major additions, sales, retirements, and other adjustments to carrying value.
- Examine deeds and title insurance policies.
- Review insurance policies and coverage.
- Determine compliance with capitalization policy.
- Test computation of depreciation amounts.
- Determine compliance with regulatory property and equipment investment limitations.
- Test compliance with lease contractual provisions.

198. For other assets the auditor's procedures include the following:

- Examine evidence supporting the carrying amount of other assets, as well as the adequacy of the allowance for losses if any.
- Send confirmation requests, as appropriate.
- Inspect real estate or review applicable appraisals.

199. Internal accounting control considerations for other assets are listed in Appendix B of this guide.

Chapter 8

SAVINGS ACCOUNTS

200. A credit union is funded primarily by members' savings deposits, which may be referred to as shares, share drafts, or share certificates. Most credit unions offer various savings opportunities normally restricted to credit union members, which may be categorized as savings or certificates.

201. Common types of interest-bearing savings accounts include the following:

- *Regular* (statement or passbook). An account that does not require a holder to maintain a balance greater than a minimum balance and does not require notice of intent to withdraw.
- *Share draft*. An account from which the holder is authorized to withdraw savings by means of a negotiable or transferable instrument or other order.
- *Money market*. A deposit account with no maximum rate of interest and with limited transfers permitted.
- *Public unit*. Deposits made by a governmental unit in a savings or certificate account.
- *Nonmember*. Savings of other federally insured credit unions, or nonmember individuals or nonprofit organizations.

202. Certificate types include the following:

- *Jumbo*. An account with denominations of $100,000 or more.
- *Money market*. An account with maturities of either six months or two-and-one-half years.
- *Minimum deposit*. An account with a required minimum deposit.
- *Notice*. An account with a notice of withdrawal and regular additions.
- *Individual retirement account* (IRA). A tax-free account for members (may also be a savings account).

ACCOUNTING

203. The members of a credit union are also its owners. The savings of the owners-members are frequently referred to as share accounts; the interest paid on the accounts is often called dividends.

204. The auditor should be aware that credit unions historically have treated members' savings (shares) as equity for regulatory purposes. The amount on deposit in a member's account bears no relationship to his degree of ownership or control in management of the credit union's activities. Credit unions are a cooperative organization, with each member entitled to one vote in the election of officials and other matters presented to the membership. Members are entitled to a pro-rata distribution of assets in excess of liabilities, with the exception of shares due its members, in the unlikely event of a voluntary liquidation.

205. Savings accounts in a credit union should be classified as liabilities on the entity's statement of financial condition. This presentation is consistent with the prevailing practice in mutually owned savings and loan associations and savings banks. Furthermore, it is consistent with the concept of liabilities expressed in FASB Statement of Financial Accounting Concepts No. 3, *Elements of Financial Statements of Business Enterprises*.

206. Member earnings on savings accounts should be recorded as expenses, regardless of their designation as interest or dividend expense. This expense represents the cost of acquired funds from members.

207. Individual accounting records and documentation are maintained for each member's savings account. The records may be individual ledgers; however, many credit unions maintain these records on EDP equipment operated by the credit union or a service bureau. Each account is assigned a number, and membership (signature) cards are generally filed alphabetically to facilitate cross-referencing. Periodically, members are provided with statements of account activity, which detail additions, withdrawals, and adjustments.

208. Credit unions maintain subsidiary ledgers to record their members' deposits, classified according to type of account. Savings accounts, commonly referred to as shares, are interest- (dividend) bearing accounts subject to withdrawal on notice by the member. These accounts are paid interest (dividends) in accordance with credit union policy. The rates, terms, and conditions are determined periodically by the board of directors. Credit unions may have share draft accounts available to their members that pay interest at a predetermined rate, and periodic statements are issued listing all transactions. Credit unions may also offer savings certificates with various maturities and pay several rates of interest (dividend) in accordance with board policy and/or current federal and state regulations. These certificates pay a certain rate, provided the funds remain on deposit for the agreed-upon term. Often there are penalties for early withdrawal.

FINANCIAL STATEMENT PRESENTATION

209. Savings accounts of credit union members represent the most significant liability of a credit union and should appear as the first item in the liabilities and equity section of the statement of financial condition. The classes of savings should be reported in a note to the financial statements. Interest paid or accrued, commonly referred to as dividends, should be treated as an expense in the statement of income, and dividends payable to members should be shown as a liability.

AUDITING

Objectives

210. The principal objective in testing a credit union's savings accounts is to obtain reasonable assurance that the savings account balances and related expense accounts are fairly stated in conformity with generally accepted accounting principles and that the accounts are properly classified in the financial statements.

Procedures

211. Audit procedures include agreeing the underlying subsidiary deposit records with the general ledger control accounts and requesting, on a test basis, confirmation of account balances with members.

212. Internal accounting control considerations for savings affecting the audit scope are detailed in Appendix B of this guide.

213. Trial balances of the detailed savings account ledgers (EDP or manual) should be tested for mathematical accuracy. The auditor should maintain control of the trial balances and ledgers to prevent unauthorized adjustment of the accounts until he completes his testing. The auditor may decide to perform certain audit procedures at an interim date (see chapter 2). If so, he should be satisfied that the controls on which reliance has been placed, if any, are still in effect at the financial statement date. The auditor should also consider the necessity of testing transactions that have occurred since the interim examination.

214. Additional tests may include, but are not necessarily limited to, the following:

- Review the control over origination of, and access to, signature cards.
- Test the daily deposit and withdrawal slips in relation to receipts and disbursement totals.
- Compare the withdrawal slips to the applicable subsidiary record and signature cards.
- Review the control over origination of, and access to, mailing address files.
- Review the control over mail receipts.
- Test accounts for compliance with the credit union's policy regarding penalty interest recognition.
- Review dormant accounts and transactions relative to deceased accounts, particularly life savings insurance claims.
- Test compliance with Internal Revenue Service Form 1099 reporting.
- Test compliance with state escheat laws.
- Test service charge income in accordance with board policy.
- Test transactions and restrictions on savings accounts pledged as collateral for loans.

215. Confirmation of savings account balances should be requested from members. The extent and type (positive and negative) of confirmations and methods of selection (including audit sampling) are left to the auditor's discretion. Confirmation requests generally should be prepared as of the date selected for performing other auditing procedures for subsidiary ledgers. They ordinarily should include a representative sample of active and dormant accounts, large and unusual accounts, and accounts closed during the audit period.

216. Some members may have instructed the credit union that their accounts are on a "no mail" basis. There should be a written request from the member authorizing the "no mail" status. Those accounts and accounts for which confirmation requests are returned

undelivered by the postal authorities should be subjected to alternative procedures, such as confirmation by personal contact with the member or a review of account activity. If alternative procedures are not practicable, the auditor should consider whether a scope limitation exists.

217. Accrued interest payable, interest (dividend) expense, and service charge income should be tested in connection with the audit of savings accounts. Test procedures for interest on savings include the balancing of subsidiary records with the general ledger controls, recalculation of interest paid and accrued interest payable, and testing of interest expense for a specified period. Overall tests of interest may be performed by relating interest expense for the period under examination to the average balance of the respective interest-bearing savings accounts and comparing the resulting yields to interest rates in effect during the period. Service charge income should be tested to determine that the fees were charged in accordance with the credit union's policy.

218. The NCUA Interpretive Ruling and Policy Statement 80-12, issued January 28, 1981, prescribes minimum standards for the use of audit sampling for confirmation of members' accounts in federally insured credit unions. IRPS 80-12 states:

> When a certified public accounting firm is engaged by the supervisory committee to perform a verification of members' accounts, it may use whatever method of random statistical sampling it deems appropriate, which is consistent with generally accepted auditing standards (GAAS) of the American Institute of Certified Public Accountants. The verification activity must be a part of an audit that will result in the issuance of an audit report expressing an opinion on the financial statements. The opinion must be unqualified with respect to members' accounts. Otherwise, the certified public accounting firm will be subject to the . . . minimum standards.

219. The auditor should be aware that SAS No. 39 provides that either nonstatistical or statistical sampling, when properly applied, can provide sufficient evidential matter; therefore, GAAS does not require the use of random statistical sampling.

Chapter 9

BORROWED FUNDS

TYPES OF BORROWED FUNDS

220. There are several categories of borrowed funds, including the following:

- Notes payable (to other financial institutions, the Central Liquidity Facility, the Federal Reserve Bank)
- Promissory notes to members and nonmembers
- Mortgage payable or capitalized lease obligations
- Federal funds payable
- Treasury tax and loan note option account
- Reverse repurchase agreements

Credit unions do not issue commercial paper, mortgage-backed bonds, or subordinated debentures.

Notes Payable

221. Like other business enterprises, credit unions generally borrow money for short-term operational needs. A credit union may obtain lines of credit from other financial institutions, which are limited by regulatory authorities to a percentage of savings and equity. The Central Liquidity Facility (CLF), established by the NCUA at the direction of Congress, was created to improve general financial stability by meeting the liquidity needs of credit unions. Members of the CLF are required to purchase stock in the CLF. Borrowing from the CLF can be arranged for individual credit unions through an intermediary, referred to as a Corporate Central Credit Union, which then acts as its agent. Credit unions have access to the discount window of the Federal Reserve System.

Promissory Notes (Notes)

222. Notes, a special form of time deposit, generally bear interest at rates higher than those paid on savings accounts. Unlike savings accounts, notes may be offered ("sold") to nonmembers as well as to members of the credit union, although the majority of notes are usually sold to members.

223. The higher interest rates are sometimes limited to notes held to maturity; some credit unions impose an early-withdrawal penalty for notes not held to maturity.

Mortgage Payable

224. Credit unions sometimes finance expansion programs by using traditional mortgages secured by real estate owned.

Federal Funds Payable

225. These loans generally are one-day loans in the form of balances at Federal Reserve Banks. A credit union may borrow federal funds on a daily basis or may loan them when surplus funds permit such activity.

Treasury Tax and Loan Note Option Account

226. Credit unions may elect to transfer amounts from the Treasury tax and loan remittance option ac-

count to the Treasury tax and loan note option account. These deposits are subject to withdrawals and are evidenced by an open-end, interest-bearing note maintained at the Federal Reserve Bank.

Reverse Repurchase Agreements

227. These transactions involve an agreement to sell and repurchase identical certificates within a specified time at a specified price. Guidance for certain types of these transactions is provided in a proposed SOP entitled *Accounting for Dollar Repurchase–Dollar Reverse Repurchase Agreements by Sellers-Borrowers*.

FINANCIAL STATEMENT PRESENTATION

228. Individual borrowed fund types should be presented separately in the liability section of the statement of financial condition if their amounts are material. Notes to the financial statements should disclose the following:

- Interest rates
- Due dates
- Pledged collateral or compensating balance agreements
- Restrictive loan agreement covenants if significant

AUDITING

Objective

229. The principal audit objective for borrowed funds is to obtain reasonable assurance that liabilities and related expense accounts are fairly presented in conformity with generally accepted accounting principles and that required disclosures have been made in the financial statements or in the notes.

Procedures

230. The extent of audit procedures for borrowed funds depends on the circumstances of the engagement. Several, but not necessarily all, auditing procedures that may be considered when examining borrowed funds are the following:

- Request confirmation of terms of borrowing with the lender (including, for example, current balance, interest rate, and pledged property).
- Ascertain and request confirmation to determine the existence and terms of lines of credit and compensating balance arrangements.
- Read loan agreements, if applicable, and ascertain compliance with restrictive covenants.
- Examine notes (including cancelled notes).
- Test interest expense and accrued interest payable.
- Read the financial statements to determine if required disclosures have been made.

231. Significant internal accounting control considerations for borrowed funds are listed in Appendix B of this guide.

Chapter 10

OTHER LIABILITIES

232. Other liabilities of credit unions may include the following:

- Accounts payable
- Accrued interest payable
- Dividends payable
- Accrued wages
- Accrued payroll taxes
- Accrued audit and supervisory agency fees
- Accrued pension costs
- Accrued data processing charges
- Liability for traveler's checks and money orders sold
- Liability to the Federal Reserve Bank for savings bonds sold
- Deferred interest or loan fees
- Advance payments by borrowers for taxes and insurance
- Other accrued expenses
- Suspense accounts (items recorded and held subject to clarification and transfer to the proper account, such as unapplied loan payments and savings deposits)

FINANCIAL STATEMENT PRESENTATION

233. If material, each of the above accounts should be stated separately in the statement of financial condition or in the related notes.

AUDITING

234. Accounts such as dividends payable, accrued interest payable, and advance payments by borrowers for taxes and insurance should be audited in conjunction with the examination of the related statement of financial condition account.

235. The audit of such accounts as accrued payroll taxes, accrued pension costs, liability to the Federal Reserve Bank for savings bonds sold, and accrued wages often utilizes external reports or returns required by the government or private entity. Confirmation of balances and other details may be necessary, with the government or private entity receiving the reports or returns submitted by the credit union.

236. Internal accounting control considerations for other liabilities are listed in Appendix B of this guide.

INCOME TAXES

237. Internal Revenue Code section 501(c)(14)(A) exempts credit unions from federal income taxes.

IRS Revenue Ruling 72-37 defines *credit union* for purposes of determining federal income tax status. The auditor should be alert to future changes in the tax status of credit unions as a result of congressional action or IRS rulings or regulations. (See chapter 12 for a further discussion of income taxes.)

238. Section 122 of *The Federal Credit Union Act* exempts federal credit unions from federal, state, and local income tax. However, real property and any tangible personal property of federal credit unions are subject to state or local taxation to the same extent that similar property is taxed.

239. The information return 990, which tax-exempt organizations are required to file with the IRS, is prepared on a consolidated basis by the NCUA from year-end financial reports submitted to it by all operating federal credit unions. Individual federal credit unions therefore are not required to file this return. Some states provide similar services for state-chartered credit unions.

Chapter 11

EQUITY

240. The equity section of a credit union's statement of financial condition typically consists only of retained earnings. Retained earnings are commonly referred to as undivided earnings or undivided profits.

RETAINED EARNINGS

241. The following classifications of retained earnings may exist in a credit union.

Regular Reserve

242. This account is created and maintained by application of a regulatory formula that is computed by multiplying a percentage of gross income until the reserve reaches a specified percentage of total outstanding loans and certain other assets, referred to as risk assets. The balance in the reserve account represents a regulatory restriction of retained earnings for loan losses in excess of the allowance for loan losses.

Appropriated Retained Earnings

243. The board of directors may restrict an amount of retained earnings for a specific purpose. The amount is normally transferred from unappropriated retained earnings pending resolution of its purpose. The amount would be returned to unappropriated retained earnings when it is no longer necessary. An example is an appropriation for loss contingencies.

Donated Equity

244. When a credit union receives a donation of material value, such as property and equipment, the value of this asset should be established by a debit to the appropriate asset account, with a corresponding credit to this separate equity account. Donated assets should be recorded based on the estimated fair market value of the assets at the date of acquisition.

245. Retained earnings represent accumulated undistributed earnings available to —

- Comply with regulatory reserve requirements.
- Benefit members by offering below-market rates on loans.
- Benefit members by offering above-market rates on savings.
- Provide an equity base.

FINANCIAL STATEMENT PRESENTATION

246. Retained earnings should be shown as a single item on the statement of financial condition. In the notes to the financial statements or in a statement of retained earnings, significant restrictions, such as the payment of dividends on the use of retained earnings, should be disclosed. These restrictions may include those imposed by regulatory reserve requirements, state laws, or credit agreements. In such cases a notation should be made beside the retained earnings account on the statement of financial condition, indicating that the retained earnings are "substantially restricted."

AUDITING

247. The auditor should become familiar with the reserve requirements of the credit union's bylaws and applicable federal and state regulations, including the NCUSIF insurance regulations.

248. The auditor should review the retained earnings for compliance with applicable rules and regulations and should consider whether deviations should be disclosed. The auditor should also consider whether deviations should be discussed with the applicable supervisory agency.

249. The auditor should determine if there are any significant restrictions on the use of retained earnings and whether such restrictions are adequately disclosed in the statement of financial condition or in the notes.

250. In the event of a reserve deficiency, credit union operations may be limited by supervisory agencies. These limitations may include establishment of special reserves, restrictions on payment of dividends, or liquidation of the credit union.

251. If, as a result of such limitations, a significant uncertainty exists regarding the continuation of the entity as a going concern, the auditor should refer to SAS No. 34, *The Auditor's Considerations When a Question Arises About an Entity's Continued Existence*.

Chapter 12

OPERATING REVENUE AND EXPENSE

252. Income and expenses of a credit union are accumulated in revenue and expense accounts for the current accounting period until they are closed into retained earnings. Most credit unions end their fiscal year on December 31. Income accounts generally are maintained on a functional basis, for example, loans and investments. Expense accounts generally reflect operating expenses that cross functional areas and are grouped for financial statement purposes into categories such as compensation and benefits, occupancy, and data processing. If material, the provision for loan losses should be disclosed separately.

FINANCIAL STATEMENT PRESENTATION

253. The statement of income may be prepared under either of two concepts:

- *Net interest*. Interest (dividends) on savings and interest on borrowed funds are separately disclosed and subtracted from income from loans and investments to arrive at net interest income. Other expense and income items are then subtracted from and added to net interest income to arrive at net income.
- *Gross income and expense*. All income items are grouped and all expense items are grouped. Total expense is deducted from total income to arrive at net income.

254. The illustrative statement in Appendix A presents the net interest concept. Although the AICPA Credit Union Audit Guide Special Committee recommends this format, the other form is acceptable.

AUDITING

Objectives

255. The principal audit objectives for operating revenue and expense are to determine how income and expenses are accumulated and to determine that they are presented in conformity with generally accepted accounting principles, including adequate disclosure.

Procedures

256. The procedures used to audit a credit union's operating revenue and expense accounts are similar to those for other enterprises having a high volume of transactions.

257. SAS No. 23, *Analytical Review Procedures*, provides guidance for the auditor in the application of analytical review procedures. Material fluctuations of income and expense should be investigated and satisfactory explanations obtained. Overall tests of income from loans and dividends on savings should be made.

258. Income and expense are often tested in conjunction with the related asset or liability accounts. Some examples are these:

Income or Expense Items	*Asset or Liability Items*
Income items	
Interest on loans	Loans
Fees on loans	Loans
Interest on investments	Investment securities
Expense items	
Interest (dividends) on savings accounts	Savings accounts
Interest on borrowed funds	Borrowed funds
Operating expenses	Cash and accounts payable

259. The above items are high-volume, cash-oriented transactions. SAS No. 1, section 150.05, states: "Cash transactions are more susceptible to irregularities than (many other assets) and the work undertaken on cash may, therefore, have to be carried out in a more conclusive manner without necessarily implying a greater expenditure of time."

260. Internal accounting control considerations for reporting revenue and expense are listed in Appendix B of this guide.

261. The auditor should also be aware of the following:

- Certain officials of the credit union are prohibited by law from receiving compensation.
- Although credit unions are exempt from federal income tax (see chapter 10), some state-chartered credit unions may be subject to federal taxes on unrelated business income under sections 512 and 513 of the Internal Revenue Code. Unrelated business income is defined by the IRS as income accruing from activities not substantially related to a credit union's usual business operations. The auditor should be familiar with the provisions of sections 512 and 513, as well as with applicable IRS regulations and revenue rulings, to determine the extent, if any, of tax liability.

APPENDIXES

Appendix A

ILLUSTRATIVE REPORT OF THE INDEPENDENT AUDITOR AND ILLUSTRATIVE CREDIT UNION FINANCIAL STATEMENTS

262. (The following illustrates the auditor's standard report and one form of currently acceptable financial statements. Other forms of financial statements are acceptable. More or less detail should appear in the financial statements or in the notes, depending on the circumstances. The CPA should be guided by existing auditing standards concerning the report.)

To the Board of Directors
Sample Credit Union
Sampletown, U.S.A.

We have examined the accompanying statements of financial condition of Sample Credit Union as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Sample Credit Union at December 31, 19X2 and 19X1, and the results of its operations and changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Signature

Office town, U.S.A.
Month Day, 19X3

SAMPLE CREDIT UNION
STATEMENTS OF FINANCIAL CONDITION
DECEMBER 31, 19X2 and 19X1

ASSETS	*19X2*	*19X1*
Cash	$ 700,000	$ 800,000
Investments (Notes 2 and 6)	5,000,000	7,000,000
Loans to members, net of allowance for loan losses (Note 3)	44,800,000	40,900,000
Accrued interest receivable	100,000	70,000
Property and equipment (Note 4)	1,050,000	900,000
Central Liquidity Facility stock, at cost	250,000	250,000
Other assets	50,000	40,000
	$51,950,000	$49,960,000
LIABILITIES AND EQUITY		
Savings accounts (Note 5)	$42,600,000	$42,460,000
Borrowed funds (Note 6)	5,000,000	4,000,000
Dividends payable	500,000	300,000
Other liabilities	300,000	200,000
	$48,400,000	$46,960,000
Retained earnings, substantially restricted (Note 7)	3,550,000	3,000,000
Commitments and contingent liabilities (Note 9)	—	—
	$51,950,000	$49,960,000

The accompanying notes are an integral part of these financial statements.

SAMPLE CREDIT UNION
STATEMENTS OF INCOME
YEARS ENDED DECEMBER 31, 19X2 and 19X1

	19X2	*19X1*
Interest income		
Interest and fees on loans	$4,300,000	$3,450,000
Interest on investments	500,000	350,000
	4,800,000	3,800,000
Interest expense		
Dividends on savings accounts	2,500,000	2,400,000
Interest on borrowed funds	300,000	200,000
	2,800,000	2,600,000
Net interest income	2,000,000	1,200,000
Provision for loan losses (Note 3)	100,000	20,000
Net interest income after provision for loan losses	1,900,000	1,180,000
Operating expense		
General and administrative		
Compensation and benefits (Note 8)	700,000	580,000
Occupancy	200,000	150,000
Other	500,000	260,000
	1,400,000	990,000
Operating income	500,000	190,000
Other income (expense)		
Securities gains	70,000	250,000
Loss on sale of property and equipment	(20,000)	—
Net income	$ 550,000	$ 440,000

The accompanying notes are an integral part of these financial statements.

SAMPLE CREDIT UNION
STATEMENTS OF RETAINED EARNINGS
YEARS ENDED DECEMBER 31, 19X2 AND 19X1

	Appropriated			
	Statutory	*Other*	*Unappropriated*	*Total*
Balance, January 1, 19X1	$1,680,000	$500,000	$ 380,000	$2,560,000
Transfers, net	180,000	—	(180,000)	—
Net income	—	—	440,000	440,000
Balance, December 31, 19X1	1,860,000	500,000	640,000	3,000,000
Transfers, net	140,000	—	(140,000)	—
Net income	—	—	550,000	550,000
Balance, December 31, 19X2	$2,000,000	$500,000	$1,050,000	$3,550,000

The accompanying notes are an integral part of these financial statements.

SAMPLE CREDIT UNION
STATEMENTS OF CHANGES IN FINANCIAL POSITION
YEARS ENDED DECEMBER 31, 19X2 AND 19X1

	19X2	*19X1*
Funds Provided		
Operations		
Net income	$ 550,000	$ 440,000
Items not requiring the use of funds		
Dividends credited to savings accounts	2,000,000	2,000,000
Provision for loan losses	100,000	20,000
Provision for depreciation	50,000	50,000
Funds provided by operations	2,700,000	2,510,000
Decrease in investments, net	2,000,000	1,000,000
New borrowed funds	4,000,000	2,000,000
Increase in dividends payable	200,000	100,000
Increase in other liabilities	100,000	100,000
Total funds provided	$9,000,000	$5,710,000
Funds Used		
Increase in loans to members, net	$4,000,000	$2,800,000
Decrease in savings accounts, net of dividends credited	1,860,000	1,850,000
Repayment on borrowed funds	3,000,000	1,000,000
Purchase of property and equipment, net	200,000	100,000
Increase in accrued interest receivable and other assets	40,000	30,000
Total funds used	9,100,000	5,780,000
Decrease in cash	$ 100,000	$ 70,000

The accompanying notes are an integral part of these financial statements.

SAMPLE CREDIT UNION
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 19X2 AND 19X1

1. *Significant Accounting Policies*

Investments. Investment securities are at cost adjusted for amortization of premiums and accretion of discounts, which are recognized as adjustments to interest income on investments. Gains or losses on disposition are based on the net proceeds and the adjusted carrying amount of the securities sold, using the specific identification method.

Loans to members and allowance for loan losses. Loans are stated at the amount of unpaid principal, reduced by an allowance for loan losses. Interest on loans is recognized over the term of the loan and is calculated using the simple-interest method on principal amounts outstanding. The allowance for loan losses is established through a provision for loan losses charged to expenses. Loans are charged against the allowance for loan losses when management believes that the collectibility of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb possible losses on existing loans that may become uncollectible, based on evaluations of the collectibility of loans and prior loan loss experience. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrowers' ability to pay. Accrual of interest is discontinued on a loan when management believes, after considering economics, business conditions, and collection efforts, that the borrowers' financial condition is such that collection of interest is doubtful.

Property and equipment. Property and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the assets.

Pension plan. The credit union has a noncontributory pension plan covering substantially all employees. The credit union's policy is to fund accrued pension costs. Prior service costs are being amortized over thirty years.

2. *Investments*

The carrying value and approximate market value of investments are as follows:

	December 31			
	19X2		19X1	
	Carrying Value	Market Value	Carrying Value	Market Value
U.S. government and agency obligations	$4,000,000	$3,000,000	$5,500,000	$5,000,000
Common trust funds	400,000	400,000	1,000,000	1,000,000
Time deposits	400,000	400,000	500,000	500,000
Loans to other credit unions	200,000	200,000	—	—
	$5,000,000	$4,000,000	$7,000,000	$6,500,000

3. *Loans to Members*

The composition of loans to members is as follows:

	December 31	
	19X2	19X1
Automobile	$22,500,000	$21,000,000
Mortgage	8,600,000	7,500,000
Unsecured	6,000,000	5,000,000
Lines of credit	5,700,000	4,800,000
Education	1,000,000	1,700,000
Other	1,200,000	1,000,000
	45,000,000	41,000,000
Less allowance for loan losses	200,000	100,000
	$44,800,000	$40,900,000

A summary of loans by maturity as of December 31, 19X2, is as follows:

Maturity within one year	$18,000,000
One to five years	19,500,000
Over five years	7,500,000
	$45,000,000

A summary of the changes in the allowance for loan losses is as follows:

	Year Ended December 31	
	19X2	19X1
Balance, beginning of year	$100,000	$ 70,000
Provision charged to operations	100,000	20,000
Loans charged off	(10,000)	(15,000)
Recoveries	10,000	25,000
Balance, end of year	$200,000	$100,000

Loans on which the accrual of interest has been discontinued or reduced amounted to $300,000 and $100,000 at December 31, 19X2 and 19X1, respectively. If interest on those loans had been accrued, such income would have approximated $10,100 and $4,600 for 19X2 and 19X1, respectively. Interest income on those loans, which is recorded only when received, amounted to $3,000 and $1,700 for 19X2 and 19X1, respectively.

4. Property and Equipment

Property and equipment is summarized as follows:

	December 31	
	19X2	19X1
Land	$ 100,000	$ 100,000
Building	650,000	650,000
Furniture and fixtures	200,000	150,000
Office equipment	300,000	150,000
	1,250,000	1,050,000
Accumulated depreciation	(200,000)	(150,000)
	$1,050,000	$ 900,000

5. Savings Accounts

A summary of savings accounts is as follows:

	December 31	
	19X2	19X1
Share drafts	$ 3,500,000	$ 3,750,000
Regular savings	19,500,000	20,500,000
Money market accounts	12,500,000	10,000,000
Savings certificates	7,100,000	8,210,000
	$42,600,000	$42,460,000

A summary of savings accounts by maturity as of December 31, 19X2, is as follows:

No contractual maturity	$23,000,000
Maturity within one year	14,000,000
One to two years	3,000,000
Over two years	2,600,000
	$42,600,000

Dividend rates are set by the board of directors, and dividends are charged to operations.

6. Borrowed Funds

Borrowed funds are as follows:

	December 31	
	19X2	19X1
Central Liquidity Facility, 15% due 19X3	$1,000,000	$ —
Dollar Credit Union, 11% unsecured notes, due 19X3	2,250,000	—
First Trust Bank, 8.25–8.75% notes, due 19X2	—	1,500,000
Reverse repurchase agreements, 10%, secured by U.S. government obligations, due 19X3	750,000	—
ABC Co., 7.25–7.5%, due 19X2	—	500,000
Promissory notes, interest at 7.5%, due 19X3 and 19X2	1,000,000	2,000,000
	$5,000,000	$4,000,000

7. Retained Earnings

The Sample Credit Union is required by regulation to maintain a statutory reserve. This reserve, which represents a regulatory restriction of retained earnings, is not available for the payment of dividends.

Other appropriated retained earnings represent a restriction on the payment of dividends as established by the board of directors.

The Sample Credit Union is exempt, by statute, from federal and state income taxes.

8. Pension Plan

The credit union has a noncontributory defined benefit pension plan covering substantially all of its employees. Total pension expense was $45,000 in 19X2 and $30,000 in 19X1. Annual contributions made to the plan equal amounts accrued for pension expense, including amortization of past service cost over thirty years. Accumulated plan benefit information, as estimated by consulting actuaries, and plan net assets for the plan are as follows:

	December 31	
	19X2	19X1
Actuarial present value of accumulated plan benefits:		
Vested	$450,000	$400,000
Nonvested	100,000	75,000
	$550,000	$475,000
Net assets available for benefits	$345,000	$300,000

The assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 8 percent in both 19X2 and 19X1.

9. Commitments and Contingent Liabilities

Outstanding mortgage loan commitments at December 31, 19X2, total approximately $600,000. These commitments are not reflected in the financial statements.

The credit union is a party to various miscellaneous legal actions normally associated with financial institutions, the aggregate effect of which, in management's and legal counsel's opinion, would not be material to the financial condition of Sample Credit Union.

Appendix B

EVALUATION OF INTERNAL ACCOUNTING CONTROLS

263. The second standard of field work is as follows:

> There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

264. The definition and characteristics of the basic concepts of internal control are discussed in AICPA Professional Standards No. 1, sections 320.09 through .48. These characteristics are listed below:

- Personnel
- Segregation of functions
- Execution of transactions
- Recording of transactions
- Access to assets
- Comparison of recorded accountability with assets

265. This appendix presents a specific list of significant considerations in evaluating internal control, keyed to certain chapters in this guide, but it is not intended to be comprehensive.

266. *Chapter 3. Cash*

- Teller funds
  - Do tellers have exclusive access to, and custody of, their respective cash funds?
  - Is loss exposure reduced by limiting the amounts of tellers' funds?
  - Is a systematic plan used for surprise counts of tellers' cash funds?
  - Are tellers performing other accounting duties?
- Are physical storage facilities adequate to safeguard against loss?
- Is vault cash (reserve fund) under dual control?
- Is access to the night depository under the control of two employees, both of whom must be present when the safe's contents are removed, listed, and processed?
- Are cash items reviewed daily for propriety by a supervisory employee other than the custodian of the items?
- Are the functions of draft issuance, register maintenance, and reconciliation performed by different employees?
- Are bank reconciliations prepared on a periodic basis and properly approved?
- Are confirmation requests received from depository banks by an employee other than the one reconciling the account?

267. *Chapter 4. Investment Securities*

- Are security purchases, exchanges, and sales approved by the board of directors or by its designated committees or officials and recorded in the minutes?
- Does the board of directors receive regular reports on investment security activity showing such data as valuations, maturity analysis, and yields?
- Are accounting entries prepared by an employee not executing or authorizing security transactions?
- Are securities on hand kept under dual control?
- Are securities held by others verified periodically by physical examination, confirmation, or other procedures by persons independent of the employee responsible for control over the securities?

268. *Chapter 5. Loans*

- Are loans granted in accordance with policies established by the board of directors and the credit committee?
- Are credit reports obtained for new loans?
- Are loans properly approved by officers and reviewed by the credit committee?
- Is the performance of the three functions — loan approval, disbursement and collection, and ledger posting — appropriately segregated among different employees?
- Is disbursement of loan proceeds to the borrower in cash, if permitted, properly documented?
- Is physical protection of notes, collateral, and supporting documents adequate?
- Are ledger trial balances prepared periodically and reconciled with control accounts by employees who do not process or record loan transactions?
- Are paid notes cancelled and returned to the borrowers?
- Are supporting documents on new loans inspected for proper form, completeness, and accuracy by someone other than the lending officer?
- Are loans reviewed on a timely basis for collectibility, write-offs recorded where applicable, and allowance for loan losses evaluated properly?
- Are loans receivable and related collateral accepted, modified, and released only if properly authorized?

269. *Chapter 7. Other Assets*

Property and Equipment

- Are transactions (additions, transfers, and disposals) properly authorized and recorded?
- Do balances represent physical property installed or constructed, and is the asset a proper capitalizable item?
- Are depreciation amounts provided in relation to the estimated life of the asset?
- Are leases properly recorded?

Assets Acquired in Liquidation of Loans

- Has a capitalization policy been established?
- Is there proper control over related expense and income?
- Is there a segregation of duties between lending personnel and personnel responsible for assets acquired?
- Are gains or losses on sales recorded properly and approved?

Insurance

- Is the credit union adequately insured for asset and fidelity bond losses?

270. *Chapter 8. Savings Accounts*

- Are subsidiary ledger control accounts periodically reconciled to the general ledger?
- Are controls sufficient for closed and dormant accounts?
- Are savings and loan account statements mailed to members periodically?
- Is segregation of duties adequate?
- Is there adequate protection and maintenance of files, ledger cards, cancelled share drafts, cash received vouchers, and signature cards?
- Are employees' accounts periodically reviewed for unusual transactions?
- Is disbursement of savings withdrawals to a member properly documented?

271. *Chapter 9. Borrowed Funds*

- Is there a clearly communicated policy on limits on amounts of borrowings by type and other liability management guides?

- Is there adequate segregation of duties so that the subsidiary records are not handled by personnel who also process receipts, make disbursements, or prepare all the supporting documents for debt repayment?
- Are subsidiary records reconciled at least monthly with general ledger control accounts?
- Are repaid notes returned to the credit union appropriately endorsed and cancelled?
- Are provisions of debt agreements complied with?
- Are interest computations independently checked?
- Are periodic reports to management made, showing all important borrowed funds activity?

272. *Chapter 10. Other Liabilities*

- Are purchases authorized and promptly and accurately recorded?
- Are supplies and services purchased for approved purposes at reasonable prices?
- Are subsidiary records reconciled periodically to general ledger control accounts?
- Is there adequate segregation of duties?
- Are payments properly authorized and recorded promptly and accurately?

273. *Chapter 12. Operating Revenue and Expense*

- Are income and expenses recorded in the proper accounting period?
- Are income and expenses classified to permit an accurate evaluation of operating results?
- Are prepared budgets compared with actual operating results and are explanations obtained for variances?
- Are payroll costs promptly and accurately recorded?
- Are payroll payments made in the correct amount to employees of the credit union for services actually performed?
- Are detailed and overall tests of loan income and dividend expense performed?

Appendix C

GLOSSARY

ALLOWANCE FOR LOAN LOSSES. A contra account established and maintained by periodic charges to operating expenses to provide a balance for absorbing possible future loan losses.

APPRAISED VALUE. A valuation made by an approved or licensed appraiser based on facts, assumptions, and techniques that the appraiser considers appropriate.

CENTRAL LIQUIDITY FACILITY (CLF). A corporation formed by an act of Congress to help credit unions cope with liquidity excesses or deficiencies. The CLF provides a facility for investing and for borrowing funds.

CERTIFICATES OF INDEBTEDNESS. See PROMISSORY NOTES.

COMMON TRUST FUND. A commingling of individual trust funds into a common pool.

CONTINGENCY RESERVE. An appropriation of retained earnings set aside for possible future contingent liabilities.

CORPORATE CENTRAL CREDIT UNION. A credit union organized by credit unions to offer a central deposit and lending facility for credit unions.

CORRESPONDENT CREDIT UNION. A credit union that acts as an agent and processes transactions for members of another credit union pursuant to a service agreement between the two credit unions.

CREDIT COMMITTEE. A committee of credit union members that is responsible for the approval and general supervision of all loans to members, subject to federal and state laws. It may delegate its authority to loan officers.

CREDIT UNION EXECUTIVE SOCIETY (CUES). An organization designed to provide a forum for credit union executives to exchange ideas and to disseminate information.

DIVIDENDS. The amount paid to a member in return for his or her savings in the credit union. In the aggregate, this is an expense for financial statement presentation.

DORMANT ACCOUNT. A savings account in which there has been no activity other than dividends credited for a specified period of time.

ESCROW. An account credited with periodic deposits by borrowers for credit union payment of real estate taxes and insurance premiums when they become due.

FEDERAL HOME LOAN MORTGAGE CORPORATION (The Mortgage Corporation or FHLMC). A corporation that provides a secondary market in conventional real estate mortgages. It sells mortgages and mortgage participation certificates (PCs) representing undivided interests in a group of mortgages. It is often referred to as *Freddie Mac.*

FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA). A corporation that provides a secondary market for residential housing mortgages. It is often referred to as *Fannie Mae.*

FEDERAL RESERVE BOARD (FRB). A board of seven members appointed by the President and confirmed by the Senate and responsible for supervising, coordinating, and formulating monetary policy. The FRB has regulatory power over member banks and nonmember financial institutions.

FEDERAL RESERVE SYSTEM. The central banking system of the United States, created by the Federal Reserve Act of 1913. The system includes national and state member banks and twelve Federal Reserve Banks and their branches.

FIELD OF MEMBERSHIP. The group of people who qualify as members of a credit union. A credit union's field of membership is limited by law to those who have a common bond, such as a place of employment, community, or association.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA). A corporation wholly owned by the federal government that purchases, services, and sells mortgages insured or guaranteed by the Federal Housing Authority (FHA) and the Veterans Administration (VA). It also performs other secondary market functions to support the home mortgage market. It is often referred to as *Ginny Mae.*

LEVEL-YIELD METHOD OF INTEREST COMPUTATION. The recording of premium amortization and discount accretion in a manner that produces a constant rate of return on the carrying amount of an asset.

LOAN FEES. An amount charged for a loan generally to cover the cost of origination and as a yield adjustment.

NATIONAL ASSOCIATION OF STATE CREDIT UNION SUPERVISORS (NASCUS). An organization of state credit union regulators formed to encourage legislative support for state credit unions.

OPEN-END CREDIT. An arrangement under which a lender provides a specified line of credit that may be used at a borrower's discretion. It is also called a *charge account* or *revolving credit account.*

PASS-THROUGH CERTIFICATES. A certificate guaranteed by GNMA, representing a share in pools of mortgages insured by the FHA, VA, or Farmers Home Administration. The pools include mortgages with the same interest rate and approximately the same maturity. The payback to investors includes interest and principal, both guaranteed by GNMA. Such a certificate has a minimum trading unit amount.

PAYROLL DEDUCTIONS RECEIVABLE. A receivable due from a sponsor organization for amounts withheld from employees' salaries for a specific purpose.

PROMISSORY NOTES. A note issued in evidence of an agreement with a member. In essence, it constitutes a loan to the institution. *Interest* is paid on a promissory note, which is also referred to as a *certificate of indebtedness.*

REPURCHASE AGREEMENTS (REPOS). An agreement under which a credit union purchases securities and the seller agrees to repurchase them within a specified time at a specified price.

REVERSE REPURCHASE AGREEMENTS (REVERSE REPOS). An agreement under which a credit union sells securities and agrees to repurchase them within a specified time at a specified price.

SAVINGS CERTIFICATES. A time-deposit certificate issued in evidence of an agreement between the financial institution and a member. A substantial penalty is required for early withdrawal of funds. *Dividends* are paid on a savings certificate.

SECONDARY MORTGAGE MARKET. A market where transactions primarily between mortgage owners (who wish to sell mortgage loans) and investors (who are willing to buy mortgage loans to hold for income) involve the purchase and sale of existing mortgages. These mortgages may involve guaranties by government agencies, by private institutions, and by investors throughout the United States.

SHARE DRAFTS. A dividend-bearing, checklike account. A share draft is processed through regular check-clearing channels.

SIGNATURE CARDS. A card bearing a member's signature. The card contains the contract between a member and the credit union. The card must be kept on file by the credit union for signature verification.

STATUTORY RESERVE. An appropriation of retained earnings required by statute.

STUDENT LOAN MARKETING ASSOCIATION. An organization created by an act of Congress to provide a secondary market for buying, selling, and servicing student loans. It is often referred to as *Sallie Mae.*

SUPERVISORY COMMITTEE. A credit union committee that is responsible for an annual audit and for an annual report of the credit union's operations. A summary of the report is presented at the annual meeting of members.

TREASURY TAX AND LOAN NOTE OPTION ACCOUNTS. In the aggregate, balances in a credit union representing payments for certain U.S. obligations and payments of federal taxes that the credit union elects to retain and pay interest on to the Treasury for short-term periods.

UNAPPROPRIATED RETAINED EARNINGS. Retained earnings of a credit union not restricted for specific purposes. It is commonly referred to by credit unions as *undivided earnings.*